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July 12, 2004

Mr. Jonathan G. Katz
Secretary
Securities and Exchange Commission
450 Fifth Street, NW
Washington, DC 20549-0609

Re: File No. S7-21-04

Dear Mr. Katz:

This comment letter responds to the Commission's ABS proposals. Our group has been creating mortgage- and asset-backed securities for clients since 1973. Most of my contemporaries were obviously better at this than I, since they are now comfortably retired.

BACKGROUND

Thirty-one years' experience has taught me that asset securitization is, in the end, all about financial intermediation and its cost. Conventional finance is fundamentally different from structured finance. Conventional finance increases leverage and allocates the risk of an enterprise among investors. Structured finance, when done properly, does not increase leverage. It only transfers assets from one group of investors to another.

Good securitization increases liquidity and lowers the net cost of funding the productive side of an economy. There is no other legitimate or long-term purpose for this process. While good securitization reduces the cost of intermediation, abusive securitization raises that cost by seeking to hide the increasing leverage of conventional finance within a perception of an asset transfer. Such deceptions reduce investor confidence and increase the cost of intermediation, to everyone's detriment.

The goal of all securities law and regulation is to support the public's interest in sound financial markets with assured investor protection. When combined with investor protection, the public interest is best served by enhancing financial market intermediation and reducing its cost. Good securitization helps capital markets to achieve this goal. Therefore, rules should be created to support securitization (or, if one prefers, structured finance) when it is not abused.

The history of modern structured finance, as reflected in the accompanying study, shows the importance of distinguishing good structured finance from disguised conventional finance. Once distinguished, the trading function of structured finance is a process where issuers and investors are, in fact, interchangeable. Today's investors (buyers) are necessarily tomorrow's issuers (sellers), so

their long-term interests are identical. It is the leverage of conventional finance which permanently separates the interests of issuers and investors.

We hope you will find the comments and analysis helpful.

U.S. SECURITIZATION EXPERIENCE

With 34 years of experience securitizing financial assets, the U.S. has a history which shows how intermediation costs fall, and markets thrive, when good securitization practices expand. But if securitization is allowed to be abused or controlled by a few market makers, we can also see from our history that debt intermediation costs skyrocket and markets fall as a result. Abuses can never be completely stopped. They can, at least, be minimized by eliminating needless barriers to good practices and requiring that abusive practices be disclosed properly to assure appropriate investor and regulatory scrutiny.

The accompanying study details this experience and analyzes it. What follows is a summary of what this history and analysis show.

Over time, nobody benefits from high intermediation costs (fees, spreads or commissions). In the short run, some will, of course, make extraordinary income off high commissions and spreads. As successful traders become investors themselves, however, high intermediation costs eventually erode the wealth they gain and, as Keynes observed: "In the long run, we're all dead." Excess trading profits systematically erode the wealth of their clients, their firms, the productive sector of society and, ultimately, the wealth of the nation as a whole.

The Commission has recognized the debilitating effect of high intermediation costs. By its recent "decimalization" of stock prices, for example, the SEC succeeded in lowering minimum equity commissions. Traders complained, of course, but over time a savings of even one basis point in intermediation cost creates an enormous benefit for everyone. By assuring proper and competitive securitization procedures, history shows that the Commission can produce far greater benefits for debt financial markets (which are much larger than the stock market).

During the 1992 to 1998 "Goldilocks" Era of U.S. finance, fostered by new and freer securitization processes, standard indices (analyzed in the attached study) show that the cost to intermediate unrated corporate debt fell by about 150 basis points with no harm to investors. On an annual basis, that's perhaps 75 times the possible savings produced by decimalization. In periods before and after the "Goldilocks" Era, lack of effective securitization and abuse of securitization, respectively, allowed this intermediation index to rise by roughly 650 basis points, more than 300 times the potential savings of decimalization.

Structured finance, therefore, deserves a lot of attention. It takes a lot of trades to match the benefits that low and competitive debt intermediation costs provided during the 1992-1998 time frame.

The Commission's effort to open competition in securitization markets by publishing all its issuance standards for public ABS offerings is an enormous step in the right direction. Assembling all the rules for public securitization in a single location will certainly expand access to this essential knowledge. Making certain that those rules will have their desired effect, however, is at least as important as codifying them in one location.

The study surveys intermediation costs in markets directly affected by securitization and supports the need for free, fair and open competition in this vital area. As noted in one of the articles attached to the study, securitization can only operate correctly when all unnecessary barriers to good markets are removed and all loopholes which permit abuse of securitization are firmly closed. That is a daunting task for all who set market rules.

Achieving the necessary balance for securitization markets will require the SEC, the FASB and other regulators to challenge themselves by a standard which is regretfully seldom voiced in the inner circles of financial markets, "true competition." Throughout history, bankers and investors have been reluctant to open markets. After all, a pocketbook is generally carried next to a man's heart and the basis for one's own investment decisions are seldom divulged. To suggest that markets are better served by the helter-skelter nature of open competition runs counter to the basic instincts of investors. Yet, history proves this to be the case.

Lowering the aggregate price of debt intermediation does not mean that the particular price of any loan should be reduced or that the Federal Reserve Board should not raise rates to address economic events.

Every loan must be priced properly. An underpriced loan creates a loss risk that no banker can expect to avoid. Conversely, however, an overpriced loan also creates a risk of loss that no banker can expect to avoid. In the first instance lenders attract bad loans, and in the second instance they make loans which impose too great a burden on borrowers, creating future loss.

Seasoned bankers know that it is only by truly open, fair and full competition that loans can be properly priced. When markets are closed, limited competition will produce overpricing that creates loss. When markets are "jawboned" or speculatively abused (*e.g.*, the 1980s S&L debacle) to create loans priced too low, markets overheat and create loss.

Structured finance (securitization) is the process by which any group can competitively fund loans. It is competition, with full and fair disclosure and open pricing in the markets these groups create, which assures the proper funding rate for loans in a true free-market economy. The U.S. must lead the process to develop markets which display these characteristics unless it wishes to surrender leadership to others. The new Governor of the Bank of Japan, for example, Toshihiko Fukui (whom some call "Japan's Greenspan"), clearly understands the importance of efficient financial systems and is pushing Japan's banks by actively fostering securitization's development.

Ultimately, the need of all parties to fairly and competitively price financial assets will force solutions for the remaining concerns of securitization. As the source for up to 85% of all financial intermediation, it is in the world's interest that the U.S. create those solutions. The Commission's ABS proposals are one important step in a direction, therefore, which cannot and must not be avoided.

Properly done, structured finance is itself a trading process, not a process for increasing obligations to be traded in markets. It is by balancing the interests of issuers, investors and intermediaries that we create trading markets which are "not too hot and not too cold." The SEC took unprecedented steps to create such an equilibrium when it amended shelf registration rules in 1992. That effort also incorporated the results of a thorough review of impediments to securitization created by the Investment Company Act of 1940 (the '40 Act), and rules thereunder. Regretfully, the Commission has failed to address '40 Act impediments as part of the current review process.

As noted in the study, many "fingers" of analysis point to amendments which the Commission adopted in 1998 to '40 Act Rule 2a-7 as a prime source of the dis-equilibrium and extraordinary volatility we've seen (particularly in corporate debt markets) since 1998. The ruinous impact of that volatility on our economic welfare is hard to understate. When lost opportunity is added to actual investor losses, the total impact of undoing the 1992 to 1998 "Goldilocks" Era may exceed $10 trillion.

THE ABS PROPOSAL

The Commission's ABS proposal, while laudatory in its intent, contains some pitfalls and barriers that could easily upset a fragile equilibrium which now exists in financial markets. Resolving these issues fairly and quickly is important to our nation's economic health. In addition to specific recommendations for fixing '40 Act Rule 2a-7 (contained in the attachments), policies and procedures in the ABS proposal described below should be analyzed for market impact and revised. Moreover, extensive and careful comments of all market participants deserve a full and balanced analysis to the end of producing final rules that truly enhance ABS market efficiency.

ABS markets must balance the shifting interests of investors and issuers. To achieve that result, these parties must be viewed as interchangeable for the Commission's final ABS rules to be truly effective. As "trading" instruments (not leverage devices), all matters that vitally concern ABS issuers today will equally vitally concern today's investors tomorrow, as today's investors seek to be issuers so as to liquefy what they bought.

COMMENTS:

1. Static Pool Information

Properly used, there can be no doubt that static pool information is of great value to investors. But we should not get swept away in a belief that it is a panacea for all market ills or that static pool information is essential for fair and full disclosure.

When static pool information is combined with full knowledge of how external factors (economic conditions, market interest rates, employment data, regional market conditions, etc.) affect a pool, the data allows rating agencies and highly sophisticated investors to rather accurately predict both (a) the frequency and severity of defaults which a pool of financial assets will experience from origination to final collection and (b) where a particular pool ranks in its expected life cycle of loss. Securities law disclosures, however, are not supposed to supplant the expert judgments of (i) rating agencies or (ii) highly sophisticated institutional investors.

When presented as mass data or without context, static pool information can be both confusing and as misleading as any other type of default and loss presentation. To require all securitizers to present static pool data as a condition to S-3 registration, moreover, would eliminate market access for an important class of arbitrage securitizers, reducing market liquidity and harming investors and issuers by raising intermediation costs. If reasons for a lack of static pool information are properly disclosed, along with a description of what such information reveals when disclosed, investors in ABS markets can give proper consideration to this disclosure gap when pricing particular ABS issues. Over time, market prices will establish the value of good static pool data.

Perhaps the best example of a solid static pool analysis is the initial Standard & Poor's Corporation study of mortgage performance dating to the Great Depression. It laid the foundation for rating all early mortgage securitizations and provides many insights that may be helpful.

Tracing residential mortgage loans from origination to final collection to create a complete static pool, that study found a diversified pool of long-term, fixed-rated mortgages, originated to certain income standards and with at least a 20% down payment, suffered about a 15% frequency of defaults during the Great Depression. Moreover, those mortgage loans that defaulted (and did not reinstate) suffered an average loss equal to about 35% of the original loan balance. Consequently, a comparable loan pool of newly originated mortgage loans would, it appeared, require 5.25% available loss coverage (.15 x .35 = 5.25%) to sustain the economic consequence of the Great Depression.

In order to make that observation with statistical clarity, however, one had to look back from many years in the future to create a fully valid static pool analysis of losses incurred during the Great Depression. If securitizers are required to provide comparable data, some market participants would die (or go broke) before they could liquefy assets. It is absolutely certain that this kind of market closure is <u>not</u> in the best interest of issuers or investors.

Static pool data has value in converting percentage loss data to an approximation of actuarial loss data when the available percentage loss data relates to a growing pool of loans. Indeed, there are classic examples of rapidly growing asset classes where correction of percentage loss data by the more balanced insight of static pool information has revealed substantial understatements of loss. However, even the best static pool analysis is subject to error when new circumstances create new sources of either loss or increased liquidity.

Where asset pools are growing or newly originated, but lack sufficient history for a reasoned static pool analysis, commentary on the type of information that is not available (due to the lack of an actual default history) could be far more valuable than misleading or premature static pool data. To force construction of static pool data that does not exist creates a cost of intermediation barrier, a roadblock for securitization of new asset classes and disclosure issues that are potentially harmful to investors and issuers alike.

Moreover, even when available, static pool information is not without weakness. Allowing static pool data on "comparable pools" creates risk of what, precisely, is comparable. Static pool data on short-term "balloon" mortgages which were popular (indeed, required by law for some lenders) during the 1920s would show that the loans performed admirably, right up until the crash. Static pool data in 1927 would have given no mortgage investor a warning of the losses it would suffer in the crash of 1929 to 1933.

Conversely, static pool data on commercial mortgages trapped within the dying thrifts of the late 1980s and early 1990s would falsely understate how such loans performed in the mid- to late 1990s when markets re-liquefied following the SEC's 1992 rule changes. The same would be true for corporate loans if one used static pool data from 1998 through the fall of 2002 as a performance gauge applied to the period from 2002 until today.

Just as percentage loss data understates losses in a growing pool, static pool information on a loan pool which is shrinking after experiencing an unexpected early loss pattern may substantially overstate loss. Properly done, a valid actuarial loss analysis of a pool contemplates the probability that loan losses will be concentrated at certain times based on economic conditions. Thus, when greater-than-expected loss is suffered early in the life of a pool, lower-than-expected loss can be anticipated thereafter, and vice versa.

Markets where issuers and investors are interchangeable suffer when loss is exaggerated just as much as when it is understated. Disclosure of material facts is appropriate, but compelled disclosure of implicit or explicit economic prognostication is entirely inappropriate. Investors must ultimately rely on their own judgment, not issuer speculation on future events. That's the nature of a true market. History may or may not indicate future performance.

My experience is not adequate to advise the Commission on how to strike the proper balance between investor and issuer needs in this instance. Certainly, where statistically significant static pool information is not available, issuers should not be forced to invent it or be denied market access. Moreover, since market conditions change in ways that are, in general, quite unexpected, providers of static pool data should not be accountable based on changed conditions which are not controlled by the issuer. Alternative disclosures that advise investors of the value of missing information can provide full, fair and non-misleading disclosure. That is better than foreclosing market liquidity or compelling disclosure of meaningless or misleading data.

2. Defining ABS

The '40 Act Report of 1992 properly defined the purpose of ABS as "enabling companies to borrow at low cost while providing investors with high quality debt insulated from the credit risk of the company."

This result can be achieved equally well by properly structured non-recourse secured loans and by transactions which are accounted for as sales. The distinguishing feature is separation of assets from the credit risk of an issuing entity, servicer or sponsor. Abusive securitization is characterized by transactions which lack such separation.

When the payment resources of a particular transaction combine assets with future payment obligations of a sponsor or transferor, conventional leverage is created, not an asset-backed security. That is not to say that transferors and sponsors cannot provide "credit support," it is to say that such support should not materially rely on the future payment capacity of the transferor, servicer or sponsor. If it does, the transaction is closer to conventional finance than ABS.

Isolated cash reserves, proper subordination which is isolated and "at market" swaps that do not cover deficiencies in the performance of pooled assets are consistent with a separate "asset-backed" disclosure system. Moreover, credit support by entities with no other association with the ABS transaction is consistent with ABS disclosure, combined, where material, with conventional disclosures regarding the credit-enhancing parties. Direct limited recourse by which issuers, servicers and sponsors agree to pay a material part of future losses, however, creates risks of conventional finance that cannot be ignored and are inconsistent with the proper purposes of securitization.

An example from early structured mortgage-backed transactions may be helpful. The '40 Act Report notes that the first private mortgage-backed security (1977) was secured by 10% pool coverage from the sponsor. While only 10% of the total pool, based on the S&P study of Depression-era mortgage pools, such coverage was enough to support roughly twice the losses suffered during the worst loss period in recent memory. Regardless of GAAP or regulatory capital treatment, that guaranty brought a component of conventional finance to the transaction which supports need for different disclosures than a transaction which does not link asset performance with sponsor payment capacity. Around the time the '40 Act Report was released, moreover, bank regulators determined that this type of support merited balance sheet treatment by the affected bank for regulatory capital purposes.

If this credit-linking fundamental distinction between structured finance and conventional finance is maintained, the vast majority of ABS abuse observed since 1998 will require compliance with the conventional disclosure standards which are suited to investor needs. ABS standards should still, perhaps, be applied to asset disclosures in linked credit structures. But conventional finance disclosures should be required as well, as though the supporting servicer, seller or sponsor was an issuer.

The line to be drawn is not simple. Material future payment liability that breaches the separation of conventional finance and asset-backed finance must consider the degree of future loss, the ability of the obligor to manage loss and the degree of investor reliance. When a seller/manager agrees to pay only 5% of future losses on pools where loss has never exceeded 1%, its future payment obligation probably should trigger conventional finance disclosures. If the seller/manager isolates cash or subordinate securities to support loss, however, leverage of the seller/manager is not at issue and conventional disclosure about the seller/manager is not appropriate (indeed, it could mislead investors into assuming liability that does not exist).

When the obligor on future loss is not a seller or servicer, moreover, so it lacks the ability to manage loss, a much greater threshold seems appropriate. Finally, an originator's obligations to repurchase assets that breach representations and warranties which are reasonably believed to be true when made actually provide no credit support and should, therefore, be ignored. They merely effect a mandatory partial rescission of the original sale, with no connection to actual asset losses.

In addition to liability, at least two other issues should be addressed to define "ABS." ABS transactions do not involve parties in real "business judgment." While servicers must exercise discretion to maximize recovery when an underlying financial asset defaults or is in need of special attention, there is a point where the need to exercise such discretion generally (due to the level of defaulted or non-financial assets) converts the ABS structure into a business of managing non-financial collateral.

Where that line is crossed depends, as the ABS proposal implies, on both the nature of the assets and the passivity of the ABS entity. If the underlying collateral is so common as to be a commodity (*e.g.*, leased cars or light trucks) and the ABS entity begins operations as the passive recipient of cash flows, a higher level of non-financial assets would be proper. Where the assets are diverse pools of high-yield bonds, however, other standards probably are appropriate.

To define and separate ABS disclosure from conventional finance without addressing these critical issues will not bring closure to the problems of abuse which so badly disrupted U.S. markets between 1998 and 2002. To address them properly, however, will require the Commission to carefully weigh many factors. The goal of maximizing liquidity with assets and structures that are not linked to the credit of a particular seller, servicer or sponsor should remain the foremost consideration.

3. Third-Party Disclosures

In several instances, the ABS proposals require parties to obtain information from third parties, condition the availability of preferred procedures on disclosures which third parties control or hold parties liable for the accuracy of third-party data. Certainly, if there is to be responsibility for such data, it must fall on transaction participants, but what should be the proper degree of responsibility?

If, despite reasonable efforts, a third-party service provider decides not to provide data, should its refusal result in a liquidity crisis for the issuer? To do this is to give service providers an enormous "hammer" by which to force concessions from securitization participants. Over time, the effect of cutting off access for issuers could be a significant reduction in market liquidity, harming issuers and investors alike. These issues, perhaps more than any others, will require the Commission to balance investor and issuer interests concerning responsibility for third-party disclosures.

When ABS transactions are properly limited to assure high-quality debt based on third-party obligations insulated from issuer/servicer credit risk, problems of assuring third-party services and information reporting are collective problems of all concerned. To place full responsibility on issuers, as is typical in the case of leverage created by conventional finance, will reduce the market benefits of securitization for all parties.

Two historic examples may be helpful.

Pre-Depression U.S. mortgage-backed bond companies were, in most cases, formed on the German Pfandebriefe model. Full or limited recourse debt was issued by stand-alone entities. Though the structures might survive many other tests, they failed in the U.S. economic cycle of 1929-33 and linkage of issuers to losses on underlying mortgages meant that whole firms fell rather than particular mortgage pools. As good loans were liquidated while bad loans were foreclosed, the value of all mortgage assets fell.

In the U.S., certain issuers of non-linked mortgage-backed bonds have held collateral that actually performed to loss levels worse than those of the Great Depression (transactions concentrated in 1980s Texas mortgages). A few such issuers, though bankruptcy remote, were, in fact, reorganized in Chapter 11 proceedings. Investors in those entities were forced to accept reductions of interest rates as the underlying mortgages were refinanced to prevent defaults. By de-linking the structures for all securities law purposes (among others), several affiliated issuers survived and retained AA or AAA ratings.

When failed reports by third parties can deprive entire issuing groups market access, the rules create yet another form of undesirable linkage that can needlessly harm markets generally. The benefits of de-linking securitization structures, whether by properly measuring credit enhancement links or by recognizing the "chain reaction" problems of liability for third-party disclosure, cannot be over-emphasized. De-linkage is, ultimately, essential for systemic liquidity.

Comments of all concerned parties must be carefully reviewed to obtain a clear and pragmatic solution to these issues. Neither full liability for third-party reporting nor a complete safe harbor seems appropriate.

4. Other Issues

The Commission will receive a broad range of views from numerous groups. I have been able to review several such comment letters. Each of the commentators will bring particular needs

to the Commission that must, of course, be weighed fairly. Many of the experts' suggestions appear well-founded and in the mutual interest of issuers and investors.

In this letter and the attached study, we have sought to look beyond the excesses and abuses of recent years to seek fundamental principles which support the proper, and indeed essential, role which structured finance (securitization) provides to create vital, open, competitive and efficient debt market intermediation.

If we can sort through the abuses of securitization so as to support its proper uses without fostering abuse, a sustained, vital and growing economy can be our collective reward. At a potential saving of perhaps $10 trillion, the end certainly justifies whatever honest effort may be required.

Very truly yours,

Frederick L. Feldkamp

Enclosures

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PRESERVING THE ESSENTIAL ROLE OF STRUCTURED FINANCE

Frederick L. Feldkamp
Foley & Lardner LLP
July 12, 2004

Table of Contents

PRESERVING THE ESSENTIAL ROLE OF STRUCTURED FINANCE

Introduction

In May of 1992, the Division of Investment Management of the U.S. Securities and Exchange Commission presented a report titled "Protecting Investors: A Half Century of Investment Company Regulation" (the '40 Act Report). The '40 Act Report grew out of responses to a June 15, 1990, concept release published by the Commission, Investment Company Act Release No. 17534.

That concept release and the '40 Act Report proceeded in parallel with proposals for amendment of the Commission's shelf registration rules under the '33 Act and '34 Act. These parallel paths converged in October/November 1992 when the Commission approved Rule 3a-7 under the '40 Act and broadened the scope of shelf registration rules to facilitate the securitization of non-mortgage assets and eliminate impediments to effective structured finance that existed under the '40 Act.

The Commission's 2004 ABS proposals do not include any review or revision of '40 Act rules. When the history of structured finance since 1992 is analyzed, this appears to be a mistake that the Commission should correct.

The '40 Act Report, Its History and Consequences

A primary focus of the '40 Act Report was on securitization, or structured finance. Chapter 1 provides history of the development of structured finance from 1970 to 1992. After analyzing the history and the role of the '40 Act, the first recommendation in the '40 Act Report was that:

> "The Commission should adopt a rule exempting structured financings from the Investment Company Act, subject to requirements that would address the potential investor protection concerns presented by structured financings. The requirements -- essentially those imposed today by the marketplace -- should restrict the degree of 'management' of exempt financings, prohibit the issuance of redeemable securities, require ratings in the top two investment grades for all publicly-issued securities, and mandate independent trustees."

That proved to be a historic recommendation. This analysis will show how the Division's recommendation (along with the 1992 shelf registration and other amendments to '33 Act and '34 Act rules) fostered the "Goldilocks" Era of U.S. finance (1992 to 1998). The Division recognized the need to support structured finance, a process which had already revolutionized the way in which financial markets operate. Structured finance did not exist in its modern form when the '33 Act, '34 Act and '40 Act were passed, nor had it developed when the '40 Act was last amended (1970).

The report defined the role of structured finance, and the primary impediment to its growth as follows:

> "[S]tructured finance or securitization is revolutionizing corporate finance, enabling companies to borrow at low cost while providing investors with high quality debt insulated from the credit risk of the company. This technique has gained widespread acceptance. In fact, structured finance volume now constitutes more than half of all United States corporate bond new issue volume. This technique was not anticipated when the Investment Company Act was enacted. Thus, some but not all structured financings fall within the Act's definition of investment company but, as a practical matter, those offerings that fall within the definition of investment company cannot operate as registered investment companies within the regulatory framework of the Act as currently written."

What grew out of the '40 Act Report was '40 Act Rule 3a-7. The adoption of Rule 3a-7 and the concurrent shelf registration amendments created what may be the finest years (to date, at least) for U.S. financial markets. This "golden age" of securitization was characterized by markets that continuously moved in a stable pattern of "not too hot; not too cold" with little evidence of major abuses. This Goldilocks Era began in 1992 and did not end until the spring of 1998.

Since 1992, however, the U.S. has learned many lessons about structured finance. The '40 Act Report urged adoption of an exemption from '40 Act regulation noting that nearly 20 years of structured finance had resulted in virtually no abuse. Abuses have now blemished the history of securitization markets. They largely occurred after 1998, however, as markets became subject to a series of debilitating crises, which this report (and accompanying articles) analyze.

In 2004, we are well aware that structured finance has both its extraordinarily beneficial "uses" and its extraordinarily harmful "abuses." During the past six years, abusive securitization has helped to generate investor losses in the trillions of dollars, criminal sentences for scores of corporate and financial industry executives and managers, the demise of what was once considered America's preeminent accounting firm and fines/penalties which will likely total tens of billions of dollars by the time all the wrongdoing is addressed.

In large measure, the abuses of securitization can be traced to structures whereby issuers or sponsors effectively securitized their own liabilities, not their financial assets. Abusive securitization breached the barrier noted in the '40 Act Report of "providing investors with high quality debt insulated from the credit risk of the" issuer or sponsor. Without separating assets from the issuer's or sponsor's credit risk, securitization converts from a process with notable merit to a process for rampant abuse.

The Commission's recently published proposals to modify the way in which asset-backed securities (ABS) are sold represent a responsible effort to further the development of structured

finance markets. The ABS proposals are not without flaws, however, which commentators will certainly note to the SEC's staff.

Sifting through those comments to achieve that balance of interests which is essential for sound structured finance markets will be challenging. By its nature, structured finance can only function efficiently if investors and issuers are seen as interchangeable, and a balance of interests is created so that no side of the ABS "contract" is favored by the SEC's rules or precluded from effective market access.

Using market efficiency tests which both underlie trades and measure the performance of structured finance markets, this report looks back, to examine 1992 market assumptions contained in the '40 Act Report, reviewing developments before 1992 with a renewed perspective of history. It also surveys market developments after 1992 and describes successes and failures. It is hoped that, by understanding the lessons of history, the Staff will be better prepared to achieve a proper balance in whatever the Commission finally adopts.

Systemic Liquidity: The Sole Legitimate Role of Structured Finance

Chapter 1 of the 1992 '40 Act Report begins by describing structured finance, and how it differs from conventional finance:

> "Structured finance is a financing technique in which financial assets, in many cases illiquid, are pooled and converted into capital market instruments. 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.
>
> "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.

> 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." (footnotes omitted)

Since 1992, structured finance markets have continued to grow. Today, for example, the vast majority of U.S. commercial paper (an essential component for effective competition in corporate finance) is issued by ABS issuers. The proportion of U.S. residential mortgages which are traded today as secondary mortgage securities would astound the operators of U.S. savings and loan associations of the 1960s (before the "GNMA certificate" was created).

The importance of structured finance, however, cannot be measured by aggregate dollar volume. It is only for conventional market instruments that volume matters. As the '40 Act Report notes, "[s]tructured finance differs from conventional financing." The purpose of conventional finance is to leverage "issuer" risk. The purpose of structured finance is to "transfer" asset risk. The first is a leverage issue; the second is a trading or liquidity issue.

In conventional financing an "issuer" undertakes the obligations of debt or equity and sells those obligations through intermediaries, so as to share the risk of its enterprise with investors. The proper purpose of structured finance is exclusively liquidity, not issuer leverage. By structured finance, financial assets (obligations of someone other than the ABS issuer or sponsor) are exchanged for cash with investors (through intermediaries or otherwise). By conventional finance, issuer risk is transferred.

The volume of conventional finance, therefore, measures the creation of new systemic risk. The volume of structured finance, properly done, merely measures transfers of risk.

Transfers of risk can be achieved either by selling assets or by creating non-recourse secured debt. Therefore, GAAP reporting of securitization does not determine whether a transaction is properly classified as structured finance or conventional finance. It is the ultimate source of investor recovery which determines that distinction. When structured finance creates new future payment "issuer/sponsor" risk, it is probably being abused and should be channeled toward conventional finance disclosures.

Said another way, structured finance "securitizes assets" of an issuer while conventional financing "securitizes liabilities" of an issuer. In structured finance, whether characterized as sales or secured borrowings for accounting, "rights" of issuers are exchanged to move what Adam Smith (the father of modern economics) referred to as "the great wheel of circulation." The volume of conventional financing measures obligations. The volume of proper structured finance, on the other hand, measures only the circulation of obligations among investors.

For this reason, a separate registration system for structured finance products, as the Commission has proposed, is correct, if that system is separated properly from conventional finance.

In conventional financing, the roles of issuers, intermediaries and investors are largely fixed. In structured finance, however, those roles shift as assets trade. Issues posed by structured finance, therefore, are often more similar to concerns raised in disclosures for "mergers and acquisitions" than those of conventional finance.

In 1992, the '40 Act Report described the following reasons for structured finance. As a result of practice since 1992, many of those "reasons" are subject to dispute. Others, however, remain valid and support whatever effort is required to properly increase the role of structured finance as a financial market tool.

> "From a sponsor's perspective, there are sound reasons to securitize assets. 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. Alternatively, by selling portions of portfolios concentrated in a single industry or geographic area, for example, a sponsor may use structured financings to diversify its credit risk.
>
> "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. 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.
>
> "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. 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.

"Banks have been particularly active in using structured financings. 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. The deteriorating quality of bank assets has resulted in a significant number of downgrades of the credit ratings of United States banks.

"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. 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. 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 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. 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." (footnotes omitted)

Since 1992, market events have demonstrated fallacies and improper risk associated with the following "reasons" for securitization:

1. **"Asset securitization . . . permits a sponsor to reduce its interest rate risk. . . ."** Federal Reserve Board Chairman Alan Greenspan has described the ability of market participants to predict interest rate movements as a myth. Some have correctly done so from time to time. He notes, however, that some people have also successfully predicted the result of many coin tosses. Correctly predicting the result of 100 legitimate coin tosses does not reduce the risk of being wrong on the next "toss." When lack of prediction capacity is combined with the laws of compound interest and a continuous reduction of investment value due to transactional spreads, fees and commissions, it is misleading to suggest that interest rate risk is reduced, in aggregate, by securitization. Structured finance shifts that risk, but at a net price. For those in need of shifting such risk, and for the intermediaries that accommodate their needs, of course, securitization is an available vehicle. As a "system," however, this is not a basis for supporting securitization.

2. **"Removing certain assets from the balance sheet can boost the return on assets and on equity."** Used properly, securitization exchanges assets for cash. It, therefore, modifies a seller's risk characteristics, but it only "boosts" earnings if the seller's "bets" placed with cash received are more profitable than the "bets" which are "sold." If there really are "greater fools" who under-price risk, it is possible for issuers to reduce risk and increase returns. In aggregate, however, those gains cancel out with the greater fools' losses, when adding up results for the financial system as a whole. As Enron, Parmalat and countless other failures have now shown, "removing" assets from a balance sheet without removing associated or undertaken obligations merely hides risk from an issuer's creditors and shareholders. Exchanging assets for cash is important, but the rest of this alleged "reason" to securitize assets has now been proven mythical; indeed, it is dangerous.

3. **"[I]ncome 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."** When a financial asset is exchanged for cash and the seller has no payment obligation to assure future performance, this is a legitimate, indeed mandatory, result of securitization. When liquidity is raised by exchanging assets, gain (or loss) must be recognized for the financial system to properly balance. But that's a reason for selling assets, not for securitization per se. What the past 12 years have taught is that abusive securitization runs hand in hand with procedures where gain recognition is a primary goal, while payment obligation is retained. No systemic gain (or loss) is achieved by this reason for structured finance. This is not, therefore, a legitimate "reason" to support securitization.

4. **"[S]tructured financings may provide regulatory benefits for . . . regulated entities, by enabling them to meet their reserve and capital requirements."** As with the three other reasons noted above, this is a proper result of structured finance when done properly. When the result of structured finance merely masks a regulated entity's continuing obligations, however, regulatory relief is inappropriate, regardless of the accounting or legal result. If a regulatory capital burden is wrongly placed, regulatory capital rules should be amended. Hiding assets and liabilities by abusive securitization in order to evade regulatory capital requirements only

encourages abuse, to the detriment of everyone (including, as history shows, the abusers). Carried to this illogical conclusion, for example, securitization conducted with retained seller obligations could effectively negate all margin rules applied to debt securities. Eliminating margin rules as ill-conceived may be proper, but supporting securitization as a means of evading legitimate regulatory goals is unwise.

To criticize these four reasons for securitization, however, is not to minimize the extraordinary value which securitization provides. The '40 Act Report lists the following valid reasons for securitization:

> "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. . . . Alternatively, by selling portions of portfolios concentrated in a single industry or geographic area, for example, a sponsor may use structured financings to diversify its credit risk.
>
> "By being better able to manage its loan portfolio, a sponsor also can strengthen its financial condition. . . .
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> "Structured financings also allow sponsors to gain access to alternative funding sources. 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.
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> "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. . . .
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> "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." (footnotes omitted)

When one assimilates all of these benefits:

> **Structured finance provides means to liquefy financial markets at the lowest effective funding cost, most notably when other means for intermediation are disrupted.**

There is no higher goal that the Commission could support than this. To liquefy financial markets at the lowest effective funding cost, with full and fair disclosure, is a valid reflection of

the primary purpose for which the U.S. Securities and Exchange Commission was created. The public's interest in vibrant capital markets is maximized as efficiency rises. Efficiency, in turn, is reflected in lower costs. Therefore, by all means possible, the SEC should support the growth and perpetuation of proper structured finance markets.

Liquidity is Essential. Therefore, Structured Finance is Essential.

Al de Molina, then Treasurer of Bank of America, said:

> "What's happened over the past two years in a lot of corporate venues has supported our view that liquidity risk is the least understood and most under-managed risk in corporate America, not just for banks, but for everybody. . . .
>
> "[Strong liquidity is] insurance against death." Al de Molina, Treasurer, Bank of America, *The American Banker*, April 4, 2003, page 1.

The Great Depression, and the decade of depression from which Japan is only now emerging, have been described as the logical result of policies that created a "liquidity trap." Faced with the inability to sell assets, financial institutions stopped new lending to good credits and, as a result, watched the value of their own financial assets decline. Without alternative liquidity at rates independent of the seller's credit risk, financial institutions implode, fail to liquefy the systems they are designed to serve and markets collapse.

The 1992 SEC rules that resulted from the 1990-1992 efforts of the Divisions of Corporate Finance and Investment Management opened up liquidity, released a free flow of financial assets and began what may be the most extraordinary financial market recovery (and subsequent advance) in history. As investors competed for liquidity and were forced to recognize their errors when prices fell, during the Goldilocks Era of 1992 to 1998 markets rewarded good assets with superior prices and quickly disciplined those who speculated unwisely.

As Japan has recently opened its markets to securitization, a similar "miracle" is in process there.

Liquidity offered by securitization allows non-financial enterprises to liquefy their good financial assets in times of stress at prices which are not linked to the falling credit of the seller. As a result, the productive economy can adjust to market changes rapidly and at minimum loss of capital or jobs. Securitization allows financial markets to move capital from productive sectors in decline to those in ascendancy. As a result, flaws in structured finance, observed from 1998 to 2002, can be viewed as one cause of the "jobless recovery" from which the U.S. has only emerged after a recent resurgence of proper securitization. That resurgence did not finally hit stride until late in 2003.

Structured finance, therefore, is the proven means by which the productive sector of society can access markets without being subject to discounting based on a seller's conventional financing status. It is this "de-linkage" which distinguishes proper securitization from

conventional finance and which should guide the Commission's final ABS rules. For financial institutions with government-insured means to access conventional finance markets, this legitimate role of securitization is not as important as for those not backed by government access. As a result, securitization has sometimes served only the abusive purposes of evading regulatory capital rules and investor scrutiny when applied by insured financial institutions seeking to leverage beyond limits set by regulators and market analysts.

The Goldilocks Era of U.S. finance which began in 1992 ended with the "Hedge Fund Crisis" of 1998. A rise of abusive securitization tactics followed that crisis. While not an excuse, this response to a crisis is understandable. Institutions are managed by people. By human nature, the instinct of self-preservation more often overcomes rationality and breeds abuse in times of great stress. Rising abuse coincided with market declines of 1998 to 2002. By September 2002, *Business Week* observed that securitization, "the grease that keeps financial markets spinning," had, in effect, become sand which was grinding those markets to a halt.

Between 1998 and the end of the third quarter of 2002, investors suffered $3.4 trillion of losses ($1.9 trillion in the third quarter of 2002 alone) as investors fled suffering and abuse-littered markets. In October 2002, however, that decline reversed as a result of reforms, including those discussed below and in attached materials.

Today, while there remain many issues to be resolved, the liquidity provided by structured finance is once again propelling markets, sustaining a remarkable recovery. In the materials below, however, we will illustrate that advances since early in October 2002 may have been built on a shaky foundation. That foundation must be made sturdy for our recovery to be sustained.

Sound SEC rules, including well-conceived rules that support securitization markets under the '33 Act, '34 Act and '40 Act, should be implemented to achieve the promise of financial stability by which all benefited during the Goldilocks Era.

Riskless Arbitrage, the Mechanics of Securitization

Since inter-market trading began, traders have thrived by creating "riskless arbitrages." If gold in the U.S. sold for $10 per ounce after the California gold rush, and it cost $1 per ounce to safely ship gold to Europe, whenever a trader could lock in a net European delivery price of $11 an ounce and match it with a locked-in sale price at more than $11, the trader would profit by a riskless arbitrage.

Securitization creates liquidity by this same process. As barriers to securitization are lowered, moreover, the cost of creating a riskless arbitrage shrinks, to everyone's benefit.

A securitization arbitrage is created by purchasing raw financial assets at their separate prices and pooling them to create securities which diversify risk and match specific securities backed by the pool with specific investor interests so as to obtain a higher price (lower discount rate). Successful securitization, in turn, creates a rising demand for sellers of "raw" assets on one side of the trade, and a rising supply of preferred products on the other side of the trade, eventually bidding away arbitrage profits. This give and take supported our "not too hot; not too cold" economy with very low and very stable intermediation costs.

In the case of small assets (such as consumer loans), successful securitization can be achieved with a relatively small size pool. However, small securitizations do not offer investors the same aftermarket liquidity as large pools.

In the case of large assets (commercial loans or high-yield bonds), very large-sized pools are necessary (a) for diversity, (b) for aftermarket liquidity and (c) to overcome disparity between (i) upside benefits that match interest flows against (ii) downside losses which eliminate both income and principal. Moreover, pools must have the capacity to fund in ranges of maturities or they are subjected to a competitive disadvantage whenever market interest rates change.

In 1998, however, the Rule 2a-7 amendments made large pools unattractive to a large class of investors. That triggered a rise in spread (to cover market demands using lesser-quality structures).

In the case of long-term assets subject to prepayment, riskless arbitrages are also achieved by dividing assets into term tranches which are then matched to investor preferences (*e.g.*, collateralized mortgage obligations or "CMOs").

Measuring the effectiveness and the benefits of securitization is much easier than structuring the transactions. Inefficient riskless arbitrages require a wide spread of price. Efficient riskless arbitrages occur at very low spreads between market prices.

Using the earlier gold trade example, if transport, guarantees, duties and other expenses of making an arbitrage "riskless" total $5 per ounce, then $10 U.S. gold can only be arbitraged at a spread of at least $5. If markets are stable and free of inefficiencies so the transaction cost is only $0.5, then a riskless arbitrage would exist at any European price over $10.50. Obviously, the lower the spread the greater the trading activity, market efficiency and profit opportunity for the parties on both sides of the trade. In the case of securitization, that means greater liquidity as spreads fall and more profit for sellers and buyers.

In securitization markets, therefore, the difference between the rate earned on underlying assets and the base rate paid on comparable securitized assets determines (a) the efficiency with which securitization works, (b) the amount of systemic liquidity securitization creates and (c) the opportunity to generate investor wealth rather than trading profit. Any cost of conducting the arbitrage that is not required for a legitimate purpose, as well as any competitive advantage given to a particular side of the arbitrage, will be reflected in wider spreads. Then, either the rate required on underlying assets (*e.g.*, consumer mortgages) must rise or payments to investors must fall to cover that cost.

As economists have widely noted for centuries, any cost in excess of the lowest fully competitive financial arbitrage spread represents a "tax" on liquidity that systemically harms issuers and investors.

The Economics of Financial Market Spreads

In market reform activities of the Commission, it has been recognized that lower spreads produce more vibrant and efficient markets. The economic consequences of financial market

efficiency, moreover, have long been recognized. The lower the spread, the more wealth that is created.

As Adam Smith observed in *The Wealth of Nations*:

> "The revenue of the society consists altogether in those goods [it produces] and not in the wheel which circulates them. In computing either the gross or [net] revenue of any society, we must always, from their whole annual circulation of money and goods, deduct the whole value of the money, of which not a single farthing can ever make any part of either."

Any gain of monetary institutions by generally high and unstable spreads is compounded by their customers' leverage so any excess interest earned by the financial sector is more than offset by loss on the productive side of the economy. All of that loss, in turn, will necessarily be reflected in the investment losses by investors.

Therefore, Smith observed: "[E]very saving in the expense of erecting and supporting those machines, which does not diminish the productive powers of labor, is an improvement of the [net] revenue of the society; so every saving in the expense of collecting and supporting that part of the circulating capital which consists in money, is an improvement of exactly the same kind." Any interest cost which is greater than the "natural" competitive price of exchange creates a non-recoverable loss to society and, therefore, any reduction to the "natural" or lowest competitive price benefits all sectors of society.

In modern financial economics, this link between spread and market expansion or contraction is simplified by the economic axiom that "Savings = Investment." The sum total of all investments in the financial sector of an economy ultimately comes from the non-financial sector of that economy (national or global). Thus, the liabilities and equity of the financial sector are the total savings of society.

The net total of all financial sector assets, moreover, represents the net total of all investments made by the financial sector back into the non-financial sector. While there must, of course, be enough spread between financial sector liabilities and assets to cover competitive costs, the lower the spread between what the financial sector pays for funds and what it charges on invested funds, the more that is left to the productive side to generate growth.

Securitization arbitrages create unfettered competition which lowers the net cost of intermediation. Securitization establishes a riskless arbitrage "cap" on the spread burden of intermediation. Structured finance therefore increases funds of the productive sector to be efficiently invested in growth rather than lost in excess intermediation costs.

Thus, by laws of economics, the lower the spread observed in markets served by structured finance:

(a) the more efficiently intermediation is conducted and

(b) the faster the nation's (or world's) wealth will grow.

Credit risk of individual borrowers, of course, must always be recognized. Lenders which forget this are regularly reminded that liquidity always flows to the lowest level. Those who make higher risk loans at lower rates become inundated by loans that cannot be paid. This also was observed by Adam Smith in the eighteenth century example of the Bank of Ayr. That does not, however, justify charging one penny more than the lowest competitive rate for funds intermediation.

The attached empirical supplement tracks the successes and failures of securitization by focusing on its consequences for intermediation and spreads.

Can Market Efficiency be Related to Regulatory Activity?

Financial markets are entirely functions of law and regulation. We know that responsible regulation makes markets more efficient by increasing investor confidence and issuer participation, thereby reducing capital costs. This is particularly true in structured finance markets because investors of today (buyers) must also be prepared to become issuers tomorrow (sellers). In this market, rules which balance reasonable needs of issuers and investors are, therefore, necessary to maximize efficiency and investor wealth.

Modern structured finance began with the creation of GNMA certificates in 1970. These certificates allow originators of government-insured home loans to create tradable securities rather than seek to sell individual loans.

GNMA's innovation occurred shortly after the Federal Reserve Board first lifted Depression-era interest rate controls (on a small class of bank deposits), creating the need for securitization's liquidity. Until then, U.S. financial markets had been bank monopolies governed by regulations which were jokingly referred to as "the rule of 3-6-3." Bankers took deposits at 3%, made loans at 6% and were on the first tee by 3 p.m.

Without deposit regulation, the practice of investing short-term deposits in 30-year, fixed-rate home mortgages became a suicidal business plan. Absent a vibrant trading market in mortgages, the only question was when institutions using that investment strategy would ultimately "die."

As shown in the empirical supplement, it took 18 years of trial and error (1970-1988) to finally provide mortgage trading markets with sufficient strength to carry homeowners unscathed through the unwinding of 2,300 banks and thrifts during the S&L crisis. It was only during the Goldilocks Era of 1992 to 1998, moreover, that mortgage securitization finally achieved full stability, only to be undermined in 1998.

The impact of market efficiency on investor wealth is even more clearly demonstrated by the history of non-mortgage securitization, most notably the securitization of high-yield debt. Widespread availability of non-mortgage securitization began to emerge with the '40 Act Report's recommendation. It is important, therefore, to examine both the need for corporate debt securitization and its successes and failures since 1992.

During the period of Depression-era regulation, banking in the U.S. had been defined as a unique business which "accepted demand deposits and made commercial loans." Securitization

of non-mortgage financial assets, notably commercial loans and high-yield debt, opened the way for all traders to arbitrage these loans and, by competition, reduce the spread charged by banks. For example, the SEC's 1992 rules allowed the RTC to more effectively liquefy commercial mortgage portfolios of hundreds of S&Ls that were driven into insolvency by speculative excesses.

Rule 3a-7 and the 1992 shelf registration rules also opened markets for impaired corporations to liquefy good assets outside the banking system at rates which did not reflect their corporate impairment. By these rules, the U.S. achieved what continued to elude Japan for about a decade after 1992. We re-liquefied markets and achieved a period of stable financial market growth by 1998 which had not, it appears, ever been achieved in large free markets.

Similar to mortgage markets, however, the growth of non-mortgage securitization has demonstrated both success and failure. The efficiency which structured finance brought to the trading of non-mortgage assets, for example, ended abruptly in 1998. Rocked by abuses after the 1998 crisis, efficient trading did not return until more than a year after the turnaround of October 2002. The equilibrium of today's markets, moreover, is grounded more on the "hope" of responsible rules than on their reality.

Whether that new equilibrium is sustained or lost will depend, in some measure, on the success or failure of the SEC's ABS proposals. The SEC's responsibility seems clear. The ABS proposals are part of a necessary new rule base which supports proper ABS markets while separating those markets from the abuse of hiding conventional finance under a cloak of ABS. To achieve this, the Commission, however, must also analyze all other rules and regulations under its jurisdiction, most notably by reevaluating the effects of the '40 Act on securitization.

The Correlation Among Efficient
Structured Finance, Market Reforms and National Wealth

Attached is an empirical analysis with charts that trace riskless arbitrage spreads which reflect pricing of mortgage and non-mortgage structured finance products. Various points of interest are noted on the charts and discussed in the empirical attachment. Also included are copies of articles (and a bibliography of other articles) that cover a number of structured finance issues which have, it appears, created market impact since 1992.

When all the lessons of securitization's history are applied to the SEC's current ABS proposals:

(1) Comments must be weighed carefully to balance the interests of investors and issuers. These two sides are definitionally interchangeable in securitization markets. Intermediaries in securitization markets, moreover, are both issuers and investors. The reasonable needs of all securitization parties must be accommodated to enhance efficiency, performance and investor wealth.

(2) Standards must emerge which separate conventional finance, characterized by future payment obligations, from ABS transfers of asset risk. Proper ABS must be encouraged by its own system while "securitizing liabilities" of an issuer or sponsor must be directed toward conventional financial disclosure rules.

(3) Other rules and regulations within the SEC's jurisdiction, most notably the '40 Act rules adopted in 1998, must be revisited to assure that future markets will be balanced to avoid new crises. The articles referenced in the attachment recommend specific changes to '40 Act rules.

Respectfully submitted,
July 12, 2004

Frederick L. Feldkamp

PRESERVING THE ESSENTIAL ROLE OF STRUCTURED FINANCE

Empirical Supplement

(See the report which this supplements for defined terms and the attached exhibit for each of the Charts referenced below.)

Introduction and Chart 1

The 1992 '40 Act Report outlines the history of structured finance to that point. It does not, however, provide empirical data to measure the market consequences of various actions, for good and for bad. Using interest rate spreads, a standard measure of debt market efficiency and pricing, this supplement measures the market impact associated with events during the development of mortgage-backed securities markets. In addition, it traces events during the development of non-mortgage structured finance.

How significant are these "spread" figures? Assuming $6 trillion of residential mortgages and $3 trillion of unrated corporate debt, each basis point of change in spreads to price and measure the performance of ABS represents a potential change in income of $600 million per year for U.S. homeowners and $300 million per year for growth firms, respectively. At a 20-to-1 price/earnings multiplier, the wealth benefit of saving a single basis point in corporate spread efficiency is $6 billion.

The charts which accompany this analysis show that mortgage spreads have varied by up to 250 basis points, and corporate spreads by more than 600 basis points, following events which affected development of ABS markets. Today, that variance would mean a potential "swing" of $150 billion per year in consumer spending. For businesses, that's a swing of $180 billion per year, or $3.6 trillion of equity value at a 20-to-1 price/earnings ratio.

The benefit/detriment of good/bad rules governing structured finance markets is, therefore, enormous. Moreover, any savings continue to compound benefits year after year. Preserving the balance of rules needed to create efficient ABS markets is, therefore, extremely important.

The first chart in this series traces corporate and mortgage spreads, and the S&P 500 Index, from 1988 (the year following the last stock market crash) through today. On this chart spreads are inverted so that every "down" movement is "bad" and every "up" movement is "good." Yellow shading indicates periods of administrative change when carryover policies tend to influence markets more than a new administration.

Chart 1 is split into four sections. The dividing points are the three most significant events for structured finance since 1988. Prior to the SEC's 1992 adoption of '40 Act Rule 3a-7 (and accompanying shelf registration rules), mortgage and corporate debt market spreads evidenced extraordinary volatility, and stock markets reacted similarly. This benefited nobody except, perhaps, intermediaries that make money during volatile times. Volatility in mortgage markets virtually ceased during and after 1992. Volatility returned, however, in 1998. Spreads also subsided in corporate markets from 1992 to 1998 as beneficial riskless arbitrages allowed by

the 1992 rules brought unprecedented stability and competition to corporate debt markets. As a result, everyone prospered.

Volatility returned in 1998 after the SEC enacted amendments to '40 Act Rule 2a-7 which cut off much of the competition that corporate and mortgage arbitrageurs provided between 1992 and 1998. Those amendments granted unique market power to a select group of favored financial institutions (as explained in the attached and referenced articles). What followed was a series of crises associated with market events which, if they occurred during the prior six years, would, it appears, have barely shaken markets. The "Asian Contagion" of 1996-97 and the bond market crash of 1994, for example, had little influence on U.S. mortgage or corporate debt markets that had been supported by the reforms of 1992.

From 1998 through October 9, 2002, rising and volatile corporate spreads created projected corporate debt cost increases of $170 billion per year (a $95-billion-per-year increase during the third quarter of 2002 alone). At a 20-to-1 price/earnings ratio, the market impact of that rise in spread exactly correlates with the $3.4 trillion investors lost between 1998 and 2002 and the $1.9 trillion they lost during the third quarter of 2002. Volatile mortgage spreads after 1998, moreover, significantly affected any mortgage investors that were too large to "cover" positions without moving markets.

There were, of course, many contributing factors. What the Rule 2a-7 amendments did, it appears, was precipitate a loss of the market equilibrium that structured finance helped to create from 1992 until 1998 (the "Goldilocks Era"). Entities like Long Term Capital Management that conducted highly leveraged investment programs had relied on the automatic balance which riskless arbitrages brought to market activity during the Goldilocks Era. Their structures could not accommodate the volatility and illiquidity which arose when arbitrageurs' access to fund large ABS structures using short-term funding was cut off by the 1998 amendments.

The corporate credit crises which followed enactment of those amendments (1998, 2000 and 2002) did not occur when riskless arbitrages were available to all participants (after 1992 and before 1998). Whenever spreads rose during that Goldilocks Era, arbitrage activity grew and drew spreads in. Disruption of arbitrages, therefore, resulted in crises until alternative means could be found. That took more than four years and the solutions are still uncertain.

The final major trend change on these charts occurred on October 9, 2002. On that day the FASB approved solutions which appeared to require disclosure of off-balance sheet activities by institutions favored by the Rule 2a-7 amendments of 1998. In addition, the FASB appeared to rebuff efforts by those favored institutions to restrict short-term funds' access for "qualifying SPEs" of prospective competitors.

As a result, a new balance among funding sources began to arise for the first time since 1998. Since October 9, 2002, as corporate and mortgage markets returned to spread levels last seen in 1998 (and volatility appeared to subside), equity markets, jobs and the economy have made a remarkable and understandable recovery. The foundation of this recovery, however, remains shaky until rules are firmly in place which support a new market equilibrium.

The disastrous period from 1998 to 2002 actually "cost" investors much more than $3.4 trillion if unrecognized losses of financial institutions would have been added. The opportunity for growth that was missed during this period, moreover, far exceeds actual and potential measurable out-of-pocket investor losses.

The turnaround of 2002 has allowed banks to reverse record loan loss reserves and report record recoveries. A roughly 600 basis point drop in corporate spread since 2002 equates to about $3.6 trillion of implied direct investor recovery, of which only about 50% has been realized.

Without final rules (including the Commission's ABS proposals) that assure preservation of the advantages of riskless arbitrages allowed by well-managed structured finance, market uncertainty (*i.e.*, fear of failure) inhibits a full recovery. For six years, growth firms that ventured into leverage have paid a dear price for optimism. It will take sound rules and time to overcome this "fear" effect.

The rules required to create a reliable new equilibrium and a sustained recovery are fairly obvious (and are outlined in the attached and referenced articles). Those who seek profit from volatility and have been favored by rules "tipping" markets in their direction may truly believe that they benefit from those rules. These materials, however, show that belief to be false.

Since Adam Smith founded modern economics, economists who have studied the impact of market inefficiency have concluded that high intermediation spreads are a useless and insidious "tax" on the wealth of nations (and the world). Wide spreads harm lenders and borrowers alike, by robbing from "i" in $(1 + i)^x$, the compound interest formula by which financial wealth is generated, in a way that provides no benefits to market participants.

Measured economically, investors lost not only $3.4 trillion from 1998 to 2002, they lost the opportunity for four years of compound growth. Had the spreads observed in 1998 (and regained by 2004) persisted throughout six years of needless volatility, it is easy to project the full value of our lost investment opportunity at $10 trillion or more, roughly 25% of the entire wealth of the U.S.

As an economic matter, it is by measuring and achieving the full opportunity value of a nation's investments that we overcome economic scarcity. Financial competition, in the form of the riskless arbitrages of structured finance, is to financial freedom and fair wealth distribution as political freedom and a free press are to the problems of famine. Financial famine (liquidity crises) cannot exist where there is open competition for funding on a level, competitive financial playing field.

Preserving liquidity and reducing volatility is, in the end, both the proper goal of ABS market regulation and the demonstrable path back from six years of needless and harmful market volatility. The following analyses confirm these points by reviewing 34 years of U.S. structured finance under the efficiency microscope of market spreads.

Residential Mortgage Market Developments—1963 to 2004

Charts 2, 3 and 4 follow mortgage market price spreads (the green line on Chart 1) since 1963, when Depression-era controls still dominated U.S. mortgage markets. On these charts, spread is not inverted (here "up" is bad, "down" is good). Moreover, the scale from Chart 1 is expanded to highlight volatility.

Boxes and vertical lines are used to show the three main events since the '40 Act Report was published (May of 1992). By every standard, the period from 1992 to 1998 shows the best market performance (low and stable spreads characteristic of highly efficient and competitive markets). The periods before 1992 and after 1998 show far greater variance, creating significant economic harm for all market participants.

The trend from 2002 to 2004 is certainly promising. An absence of final rules which assure a return to market stability leaves room for considerable doubt that this trend will continue, however.

Chart 2 has 16 data points from 1963 to 1988. Each is a major turning point in the net price of residential mortgages. They each reflect stages in secondary mortgage market development:

1. In 1970, GNMA created the first modern pass-through security. This chart tracks pricing spreads for "conforming conventional" mortgages. The result of GNMA's invention apparently drew funds from this conventional loan market to the GNMA market, which supports only the FHA/VA loans which back GNMAs. Spreads on conventional mortgages rose rapidly after creation of GNMA pass-throughs.

2. In 1971, FHLMC created its pass-through structure and conforming conventional mortgages became more competitive.

3. In the summer of 1973, the Watergate scandal had swallowed Washington and markets suffered generally.

4. Mortgage markets were buoyed by creation of the first private mortgage securities. Our group prepared the legal isolation opinion for that transaction. It was the first such opinion accepted by rating agencies. Mortgages were set aside in a special purpose subsidiary and placed in custody for security holders.

5. By late 1975, inflation and political problems led to a slump.

6. In 1977, B of A created the first publicly-traded private mortgage pass-through security. It relied on limited recourse (less than 10%) for off-balance sheet treatment. Such recourse was later (1992) recognized as full recourse by banking agencies.

7. At the end of 1978, FASB accepted a report by the AICPA urging consolidation of finance subsidiaries of non-financial companies. This would eventually have the effect of restricting innovations in mortgage markets to the passive

"pass-through" structure favored by B of A and other financial institutions. For many years (until FASB's acceptance of "QSPEs"), this restrained creation of mortgage-backed bonds (which were preferable under ERISA to pass-through securities).

8. As spreads widened and installment sale treatment became available to homebuilders, despite high interest rates to defeat inflation, "builder bonds" (pay-through debt of non-consolidated subsidiaries) allowed mortgage spreads to recover.

9. As President Reagan took office, pledges of financial freedom for strapped S&Ls, combined with projections of huge spending deficits, created some fear in mortgage markets.

10. In January 1982, FASB added consolidation of finance subsidiaries of non-financial firms to its agenda. Prospects for greater certainty and disclosure now correlated with a recovery.

11. Congress passed 1982 legislation allowing broad speculation by thrifts with no real capital. FDIC Chairman William Seidman was quoted as saying: "I don't see them [S&Ls] wanting to speculate without the U.S. government guarantying their liabilities." Seeds of the S&L crisis were firmly planted. Mortgage spreads suffered.

12. Early in 1983, FHLMC introduced its "CMO" structure. Spreads fell then rose again within a few months, as it became clear that, by virtue of FHLMC's guaranty of a specific cash flow rate, only GSEs could sell this product in quantities sufficient for the market, thereby creating a monopoly. It was not until a major homebuilder created multi-class pay-through bonds with no cash flow guarantees that the market for CMOs took off. That transaction brought a new source of general competition to mortgage markets. The GSEs and Wall Street traders adopted that process and mortgage markets boomed.

13. By 1984, the market inhibitions of '40 Act "partial pool" rules (described in the 1992 '40 Act Report) became obvious. In 1984, the Division of Investment Management recommended the first 6(c) exemptive order (relating only to GNMA pass-throughs) to the Commission and it was approved. Our group represented that entity. A statutory provision which would have granted broad '40 Act relief, however, was removed from what became the SMMEA legislation. As a result, GSEs and a few very large mortgage originators gained a virtual monopoly over access to the CMO market. Spreads widened by an astounding 250 basis points to levels not seen since the days of "3-6-3" government-controlled markets.

14. After heated debate with those who gained market dominance based on "whole pool" premiums, the Commission granted one of our clients the first "partial pool" exemption applicable to all GSE pass-throughs and private mortgage pass-throughs. To the credit of the Staff of the Division of Investment Management, it saw through arguments that the "whole pool" premium was anything more than a market control premium. Within days after issuing that relief, it soon became clear that all market participants could readily qualify. The "whole pool" premium simply (and

properly) evaporated. It was an artificial charge based on the ability of a few market makers to control access to CMO arbitrages.

15. In October 1987, the FASB approved requirements to consolidate finance subsidiaries of non-financial firms. That factor, combined with 1986 restrictions on installment sale tax treatment and the exclusivity provisions of REMIC legislation, effectively ended homebuilder involvement in pay-through CMO debt structures. These "ERISA-friendly" structures could not return until FASB's "QSPE" structure won final approval. It was not until October 2002 that the ability of QSPEs to effectively compete with institutional lenders was recovered, and we are still awaiting final rules confirming this capacity. In 1987, there were increased disclosures of rampant frauds at S&Ls, particularly among a group of "Texas zombies." Spreads rose rapidly.

16. Near the end of 1987, concepts which eventually became the "Southwest Plan" (to cease the market-debilitating "Texas premium" by closing several "Zombie" Texas thrifts) began to emerge and succeeded in calming mortgage markets.

Events of 1988 through 2004 are reflected on Chart 3. Again, this chart uses lines and boxes to emphasize four distinct periods. Volatility and higher spreads occur in the period before 1992 and after 1998. The "Goldilocks" effect (from 1992 to 1998) is even more apparent in this chart. The recovery since 2002 (marred by only one brief spike—explained in the discussion of Chart 4) is also notable.

Chart 3 identifies 10 events between 1988 and 1998.

1. 1988 began with considerable concern about looming S&L losses and the inability of government to contain a growing threat to its own financial credibility.

2. Before the spring, however, the FSLIC began to complete, and push forward, the "Southwest Plan." While subsequently criticized as a "giveaway," the plan did, in fact, shut down what had become a highly publicized government-sponsored "Ponzi scheme" that was creating a mindless upward spiral in "risk" premiums on government-guaranteed deposits. Based on direct experience with the plan, it did succeed in reversing the "Texas premium." This also had a readily apparent benefit for mortgage markets.

3. As 1988 came to a close, however, it was obvious that the Southwest Plan could not fill the entire void that would be created by closing 2,300 insolvent banks and thrifts. As various bank regulatory groups bickered over how to fund closings, an adviser to incoming President Bush cornered all parties in a room until they came up with a solution. As the FIRREA legislation emerged, mortgage markets understandably experienced the effects of reduced competition from all the thrifts which would soon be closed. Spreads rose.

4. As final FIRREA legislation emerged from Congress, its reform message ("Never again") became reality and mortgage spreads began to contract. Competition allowed by a continuing flow of '40 Act "partial pool" exemptions created new competition that brought spread recovery. Between 1989 and 1991, volatility declined

from the 250 basis point range observed from 1984 to 1986 down to a 50 basis point trading range.

5. The SEC's introduction of shelf registration proposals, but without reform of the '40 Act problems, accompanied minor disruptions of the market.

6. As the course of '40 Act relief and shelf registration reform became increasingly clear, markets continued to calm.

7. The final debates preceding adoption of Rule 3a-7 and shelf registration rules, along with the emergence of new GAAP "sale" standards which would eventually replace the much-maligned SFAS 77 as the standard for sale treatment, may have triggered some market concern.

8. Following adoption of Rule 3a-7, spreads fell into a new trading range of roughly 25 basis points for more than five years. In the history of mortgage lending tracked in this analysis, nothing like that had ever occurred. Riskless CMO trading arbitrages became so well defined and competitive that a mere 25 basis points fenced in the range of profit to arbitrageurs.

U.S. market creativity had transformed a market which vacillated between monopoly pricing and excessive exuberance into a market where a mere 25 basis points of yield defined the range between increased mortgage funding and reduced mortgage funding. The "price" of mortgages relative to 10-year Treasurys settled in around 150 basis points. Each time base interest rates rose, consumer mortgage rates rose to cool consumer markets. Each time base rates fell, consumers saw immediate benefits in refinancing and the economy moved up.

When this experience is combined with securitization of corporate lending (allowed by Rule 3a-7), the true foundation for the "not too hot; not too cold" economy of 1992-1998 seems obvious. Structured finance had created a new paradigm for financial market stability.

There were "crises" between 1993 and 1998. They did not, however, affect U.S. consumer or corporate funding, so the crises passed with no systemic harm.

9. Early in 1994, the Fed "disciplined" speculation (primarily in hybrid CMO "companion" class securities supported by GSE pass-throughs). The effect on mortgage markets was about 25 basis points over a calendar quarter, followed by a revival. 1994 ended with another "up tick" as investors cleared out sour holdings. While GE's Kidder Peabody group and certain other investors were hit particularly hard, the damage of the 1994 "Bond Market Crash" cannot be seen in mortgage spreads (or corporate spreads). What Adam Smith predicted as the consequence of financial market competition came true. Those who speculated on bad investments lost money. Those who knew better (S&P had been warning investors of the dangers of companion classes for some time, but it did not rate GSE-backed securities, the source for about 95% of that class) jumped in when spreads rose and made money when they later retreated.

10. The "Asian Contagion" moved from one nation to another in 1996 and 1997. As bad market structuring, largely the result of favoring specific groups, destroyed

antiquated financial systems, U.S. markets actually gained investors. Both mortgage and corporate spreads fell.

These benign reactions to major crises must now be compared to what followed the Rule 2a-7 amendments of 1998. Chart 4 expands the period after April of 1998 shown on Chart 3. A later chart will correlate change in corporate markets after 1998 with the trend line of Chart 4. Rules that affect market behavior sometimes affect both mortgage and corporate markets; other times, for good reasons, rule changes only affect one market. The eight major points on Chart 4 relate only to concerns affecting mortgage markets.

1. The Rule 2a-7 amendments of 1998 were controversial from the start. They appeared to be based on an assumption that the "break the buck" crisis of 1994 was somehow related to the structure used for structured finance rather than the economic consequences of particular investments selected by fund managers. In fact, virtually all the damage to short-term investors in 1994 arose from the "acceleratable negative convexity" of companion class securities which, if rated by S&P, would have borne an "r" designation after their rating. It is understood, however, that up to 95% of such securities were issued in GSE CMO transactions that were not rated.

When rates were low and falling, these companion class securities priced at a point on the yield curve beyond where they actually paid off. In addition, they received a premium because of their volatility. Speculators liked that added yield. The maturities of these securities would, however, "explode" (to become very long term) when rates rose. When such securities backed short-term paper bought by money market funds, accelerated negative convexity created a liquidity shortfall as soon as the Fed increased rates in 1994.

Volatile companion securities are not, and never have been, suitable as "current assets" to support commercial paper or other short-term securities bought by money market funds. As rates rose and these securities crossed the "PAC barrier," some projected maturities of companion class securities went from less than a year to more than 25 years. Their saleable value, therefore, fell precipitously as rates rose.

For investors with staying power, companion securities can be a reasonable investment. For short-term funds subject to daily call, they are toxic waste that can (and did) destroy many investors' wealth. As noted above, investor losses in 1994 did not significantly increase net prices of mortgage or corporate debt, indicated by spreads at that time.

The attached and referenced articles discuss mistakes made in the 1998 Rule 2a-7 amendments and what needs to be done to resolve those mistakes and more permanently stabilize markets. "Companion" classes should be limited when supporting money market fund assets, as should means for excessive risk concentration (which the 1998 amendments allow). Well-diversified structured finance products, however, should be accorded a new safe harbor.

2. In the fall of 1998, General Motors Acceptance Corporation requested relief under the Rule 2a-7 "10% obligor" rule from the Staff of the Division of Investment Management. The Staff, to its credit, granted all the relief it could (a no-action letter grandfathering most existing securities). That was sufficient to resolve the Hedge Fund Crisis of 1998 (with aid from Fed rate reductions and investor activity).

As grandfathered securities matured, however, the crisis patterns of 1998 predictably returned in 2000 and in 2002.

3. The Hedge Fund Crisis caused the Fed to lower short-term rates. In 2000 the Fed's return to increasing interest rates in an environment still hampered by the Rule 2a-7 restraints apparently contributed to a new mortgage market crisis. The impact of Fed rate increases on corporate spreads in this period was much less pronounced. On the other hand, as corporate spreads rapidly rose later in 2000, mortgage spreads apparently benefited from a shift in funds and mortgage spreads fell.

4. Mortgage markets have far less need for short-term funding of the type provided by money market funds. By May of 2000, spreads widened to a point where arbitrages could be conducted without accessing money market funds and stability began to recover, slowly, over a period of two years. Even the events of 9/11/01 (which created havoc in corporate markets dominated by a few market makers) had no noticeable impact on mortgage markets.

5. In May 2002, the FASB signaled that it would finally force consolidation of "straw-man" conduits (primarily those sponsored by banks). In addition, it appeared that bank-led proposals to restrict the access of QSPE conduits to money market funds would be approved. A significant crisis hit mortgage markets and a disastrous crisis hit corporate markets.

6. The crisis in both markets began to abate October 9, 2002. The FASB made it clear that properly structured QSPE conduits would not be restricted from reissuing beneficial interests. While bank conduits would, it appears, still be consolidated, a QSPE conduit alternative would be available to "level the playing field" which had been so severely tipped in favor of a few institutions. This began the course of a remarkable recovery.

7. In the summer of 2003, accounting gimmicks used by GSEs began to come to light. Hedging activity to resolve those issues resulted in a spike in mortgage spreads.

8. As soon as the hedging activity abated, mortgage markets resumed their prior level and beneficial trend.

As a result, despite enormous disruption, we have recently recovered mortgage market spreads to efficiency levels last seen in 1998. Completing appropriate FASB rules and correcting the 1998 errors in Rule 2a-7 would, it appears, finally restore the stability of 1992 to 1998 to mortgage markets. The SEC's ABS proposals must not be approved in a final form, however, that disrupts this new beneficial equilibrium.

Corporate Debt Market Developments—1987-2004

Since the founding of modern economics, the net cost of corporate financial intermediation (in *The Wealth of Nations,* Adam Smith called it the "neat" price) has been acknowledged as among the most important (though least understood) economic variables which determine growth. The U.S. Securities and Exchange Commission has spent decades seeking means to enhance the efficiency of stock markets and measures success by the effect of rules on exchange costs. For example, the recent decimalization of stock exchange commissions was urged as a means to lower, if only by a single basis point, the charges for stock intermediation.

Surprisingly little has been written on what affects the net cost of intermediating corporate debt in the U.S. Yet, the aggregate ability of firms to leverage profitably and grow largely depends on the net cost of credit (the difference between what businesses earn on excess funds and what they pay on borrowed funds). When the net cost of credit suddenly rises we call it a crisis, but often blandly blame "the market" or "the Fed." We know that the base cost of credit is set by action of the Federal Reserve System, but many investors simply assume spreads in credit markets are set in a vast competitive marketplace. Almost nobody except theoretical economists has questioned this, perhaps because the data appeared inaccessible.

For all its flaws, the 1980s development of a high yield ("junk") bond market finally resulted in publication of a standard index for "High Yield Bonds." It has been published each day in the "Credit Markets" column of *The Wall Street Journal* since just before the stock market crash of 1987.

This index provides a means by which one can establish and analyze the effect of various events on the net (or "neat," if one prefers Smith's usage) cost of corporate intermediation for the more than 95% of U.S. corporations which are not investment-grade rated. Those firms are the acknowledged growth companies, the innovators which supply the bulk of new jobs as the economy grows.

For those firms, the net price of intermediation, in aggregate, is the difference between what financial intermediaries (many of which are government insured) must pay the productive sector for funds (the high-grade rate) and what unrated productive sector firms must pay the financial sector for term funds used to leverage and grow (the high-yield rate).

To avoid charges attributable to maturity mismatches, the charts show net intermediation cost as the difference (spread) between long-term high-grade bonds and high-yield bonds. Both figures are published daily in *The Wall Street Journal*.

A June 2004 article ("Credit Monopolies Harm Lenders and Borrowers," copy attached) analyzes this spread as a "commodity price" during the same three 1988 to 2004 periods used to analyze mortgage markets. In two of those three periods, net price of corporate intermediation varied as though a cartel set the price of credit as a commodity (1988/1992 and 1998/2002). In the third, the Goldilocks Era of 1992/1998, on the other hand, the price of corporate intermediation moved in a manner fully consistent with a vibrant, and increasingly efficient, competitive commodity market. The article provides reasons for these differences.

The difference in performance of the U.S. economy during these three periods reflects what traditional economics would predict. For centuries economists have urged the advantages of competition in finance over monopoly and of low and stable intermediation costs over high and variable costs. The cartel-like behavior of the period from 1988 to 1992 is consistent with the recession of 1991. The period of apparent competition (from 1992 to 1998) is remembered as the golden age of U.S. growth. The period from 1998 to 2002 is one also marred by crisis, recession and war. The recent recovery of spreads can also be associated with a remarkable economic recovery and a return of competition to credit markets.

Are these correlations coincidental or causal? Theory tells us they are causal. As spreads rise, funds are diverted from productive use to support Smith's "wheel of circulation." While those funds come back as purchases of goods and services, the damage which high intermediation expense causes to productive sector balance sheets is reflected in losses on investment, a non-recoverable cost. Thus, high spreads deserve their economic label as the most insidious tax of all: they are a tax with no benefits. They drive borrowers into default and force investors to accept principal losses which exceed the income produced (due to leverage and compounding).

Lack of competition, moreover, is the only logical cause of high and volatile intermediation costs for good borrowers. It is only when competition in finance is missing that good borrowers cannot go elsewhere and be favored with a more competitive price.

A second attached article ("Ending Monopoly," copy attached) outlines the problems encountered when cartel pricing is challenged, the difficulties of restoring competition and steps required to assure that future credit cartels are prevented. Since 1987, the key variable which distinguishes periods of low and stable debt intermediation cost has emerged as the availability of honest, efficient and broadly accessible corporate debt securitization.

The balance needed to achieve (re-achieve in the case of the U.S.) free and open corporate debt markets, that are largely free of either excessive control or rampant speculation, is complex. If it was not, it would not have taken nearly 300 years to develop the markets which Adam Smith explained in his famous eighteenth century treatise. When viewed in this historic light, our nation's recent troubles with scandals and lost investor confidence are understandable. Financial markets are creations of law. Creating the required market rules is enormously complex and pitfalls litter the pathways to success.

If we are to achieve the recovery which investors in U.S. markets deserve, we must take full stock of our past errors, fix them and move on. The Commission's ABS proposals are a step in that direction, but other steps, as urged herein and in "Ending Monopoly," are also required.

Putting an end to high and volatile corporate credit spreads is, perhaps, the most important economic benefit that the Commission could provide to lenders and borrowers (that is to say, all participants in U.S. markets).

What follows is a detailed empirical look at the behavior of corporate markets since 1988 and, more importantly, since the Commission amended '40 Act Rule 2a-7 in 1998. After introducing the primary trend line to be examined, we will begin with recent data from Standard

& Poor's Corporation that further demonstrates the key point of economic theory: High and variable spreads, charged to borrowers across the board, harm lenders and borrowers alike. It is, therefore, in nobody's interest to obstruct proper reforms in this market.

Eliminating the loopholes and barriers which we have erected to free, fair and open competition in corporate credit benefits all parties, including any who may have controlled markets and contributed to higher spreads. It is in everyone's interest to resolve these problems fairly and swiftly.

Structured finance, done properly, creates liquidity and the competition which narrows and stabilizes spread. When abused, however, it has the opposite effect. This can be seen by observing the performance of the spreads between high-grade debt (which the financial sector pays for funds) and high-yield debt (which growth firms pay the financial sector). Chart 5 traces this spread since *The Wall Street Journal* began publishing an index for "High Yield" debt, just before the stock market crash of 1987 (an event illustrated by the "cliff" at the left side of Chart 5).

Chart 5 will be "sliced" and compared in various ways throughout this presentation. This trend, we will see, correlates directly with financial institution loan losses and with "fallen angel" downgrades. That's logical because rising spreads reduce funds otherwise available to borrowers, causing more borrowers to default or to be downgraded. The trend inversely correlates with stock market values, which is also logical because reduced earnings attributable to rising spread which increases funding cost and slows product sales generally correlate with lower stock values.

Rising spreads show little correlation with periods of rising interest rates. Indeed, when market competition exists, spreads contract when rates rise, as lenders seek to preserve relations with good borrowers. In the period from 1987 until June 30, 2004, the Fed raised interest rates from early 1988 to early 1989, during 1994 and from the middle of 1999 until early in 2000. The big spread "spike" of 1990 started almost two years later than the Fed's actions. Rising rates in 1994 had no significant effect on spreads and spreads began to rise long before the rising interest period in 1999 and 2000.

Chart 1 shows the close inverse correlation between changes in spread and changes in the S&P 500 Index. That index contains many financial institution securities. When one combines the correlation among stock values, loan losses and spread variance, it is safe to say that no major financial market participant truly benefits from "wide" spreads (a few traders may, but not their institutions) and everyone benefits from narrow spreads.

This is, of course, the exact conclusion which Adam Smith reached more than 250 years ago. With all of the financial brainpower in America, our vast analytic capacity, freedom of expression and a uniform interest in creating financial market stability, how can the U.S. justify its "vaunted" position as the world's leading financial market and yet tolerate the suicidal financial market behavior patterns shown on Chart 5 before 1992 and from 1998 to 2002? We must not permit the misguided goals of a few traders that temporarily profit by abuse of markets to restrict true reforms.

The fact is that very little study has been devoted to seeking the "cause" of financial panics. Our best economists (and let there be no doubt, Alan Greenspan is among history's best economists) have failed to explain periodic crises. Messrs. Greenspan and Rubin called the spike observed in 1998 (the "Hedge Fund Crisis") the worst disconnect they had ever seen between real markets and financial markets. Yet, it was only temporarily fixed in the fall of 1998 with the help of an SEC staff no-action letter discussed herein.

We understand, intuitively, that financial markets are, at their base, markets of law. We trade "legal tender" and "legal obligations of repayment," which are enforceable only in "courts of law" based on legal rules and regulations. We analyze obligors based on legal obligations to fairly present financial condition. Yet, we seldom look to rules of law and accountancy, or financial market regulations, when seeking to understand why markets periodically become subject to "irrational exuberance" and "irrational panic." We too often see law and economics as separate studies, though they certainly intersect in the operation of financial markets.

It is easy to understand why markets that are set in a positive or negative direction continue in that direction and compound gain or loss. By mathematical extrapolation, benefits only compound and detriments only collapse. Judgments and the influence of change cannot be extrapolated. A noted econometrician, when asked how he knew the "assumptions" he placed in his model of U.S. economic performance were correct, replied that when those assumptions were wrong, the model would either implode or explode as it just kept reapplying them in an infinite iterative loop.

Models of actual behavior cannot, by their nature, predict turning points. In order to understand and stabilize behavior in U.S. corporate debt markets, we must analyze the rules which govern our markets and events which, when applied using market rules, are consistent with (a) increased variance and (b) increased stability. That is to say, we must analyze the "market" impact of events at turning points, as discussed in the prior section on mortgage markets.

First, however, let's focus on the correlation between spreads and the value of loans. Chart 6 tracks spreads from 1988 to 2004 against S&P data on bank losses and "fallen angels." Each of the trends rises and falls in rough unison. The correlation is both obvious and logical. As spreads increase generally, rather than only when based on particular winners and losers, more "losers" are created, as previously "good" borrowers become "bad" when they can't afford to pay higher intermediation costs.

This is what distinguishes a credit culture of "relationship" banking from "market" banking. The spread chart reflects widening <u>between</u> high grade and high yield. It has nothing to say about credits that "slip" from high grade <u>to</u> high yield as a result of other factors. It is a result of higher spread that bank losses and "fallen angels" increase, not vice versa.

When individual credits are separately analyzed, some will always deserve higher interest rates and others will justify lower rates. When widening "market" spreads are applied to credits generally, however, the obvious (perhaps inevitable) result is to merely push more debtors into financial difficulty, to the detriment of everyone. That's what Chart 6 illustrates.

A variance between bank losses and "fallen angels" observed on Chart 6 from 1998 to 2000 is explained by noting that banks received the assets of fallen hedge funds and reduced their losses by selling those assets when markets recovered after the SEC staff grandfathered pre-July 1 securities from the effects of the 1998 Rule 2a-7 amendments. "Fallen angels" would not enjoy that same recovery capacity.

Chart 7 repeats Chart 5 (excluding 1987 data) adding the three events which, as discussed in the prior section, separate the post-1988 markets into four periods. Unlike mortgage spreads, there is no need to "inflate" the vertical axis on this chart to show variations between these periods. The different patterns are quite obvious.

As noted in "Credit Monopolies Harm Lenders and Borrowers," using spread as the net "price" of credit for the growth sector as a whole, the pre-1992 and post-1998 periods show behavior consistent with a credit cartel, while the "Goldilocks" Era from 1992 to 1998 is consistent with increasing competition and efficiency.

Charts 8 to 10 "invert" corporate spreads to show how the S&P 500 Index tracks with spreads. As spreads rise, stocks fall, and vice versa. Chart 8 shows the period before 1993. Chart 9 shows the period after 1997. As noted above, when cost of funds increases are computed and given a P/E ratio of 20, the market losses from 1998 to September 30, 2002, correlate directly with the negative value of lost earnings due to higher intermediation expense. This is a logical but nevertheless surprising result.

October 9, 2002, was the high point of spreads on Chart 9 and the low point for not only the S&P 500 Index, but also the Dow Jones 30 Industrial, the Nasdaq and the Russell 2000 indices.

Chart 10 shows very different performance of spreads and stocks during the "Goldilocks" Era. When one considers the impact of the spike of 1990 (Chart 8) on corporate boards at the start of this period, it is understandable why new leverage and consequent growth was delayed until near the end of 1994. Moreover, while corporate markets were not substantially affected by the bond market debacle of 1994, it had an understandable impact on investor and business confidence. As a result, the benefits of narrowing and stable spreads could not have their theoretical effect until 1995.

Once the rally got rolling, however, it is also easy to understand how momentum carried stocks right past rising spreads of the 1998 Hedge Fund Crisis, into a period of truly "irrational exuberance" by 2000. It takes a fairly long time, sometimes, for investors to figure out that their dreams have turned into the nightmares which began in the spring of 1998.

Chart 11 repeats Chart 7 but adds mortgage market spreads (now on the same scale). This shows just how much more volatile corporate markets have been than mortgage markets. Since mortgage securities had a 22-year head start on creating efficient securitization procedures, it is understandable that corporate markets would take time to develop stable structured finance processes after Rule 3a-7 allowed such transactions using corporate loans.

What Chart 11 shows most clearly is that our most serious market blunders began at or about the point at which the 1998 Rule 2a-7 amendments became effective. The Commission's

failure to undertake an examination of the impact of these '40 Act rules on debt intermediation is, therefore, the most fundamental flaw in its current ABS proposals. Other flaws can easily be corrected in the current rulemaking. Fixing Rule 2a-7 may prove more difficult, but it is essential.

The recovery we have enjoyed since 2002 will remain uncertain and disquieting to thoughtful investors until the problems which generated the volatility observed from 1998 to 2002 (for corporate debt and mortgages) are understood and properly resolved in the governing rules of U.S. markets. Understanding and correcting those 1998 amendments are vital to restoring the long-term confidence of issuers and investors. Their impact is the least understood yet most powerful factor affecting market competitiveness during the period after 1998.

Chart 12 details variance in spread after the Rule 2a-7 amendments took hold, and incorporates the relevant S&P bank loss data and "fallen angels" material from Chart 6. It identifies 20 "turning points." The first 19 points are discussed in two attached articles ("Who Let the Bears Kill Goldilocks?" and "Credit Monopolies Harm Lenders and Borrowers"). The 20th turning point coincides with the announcement of Alan Greenspan's re-nomination as chairman of the Fed.

From the date on which the SEC circulated its ABS proposals (turning point 19) until turning point 20, corporate spreads had been widening. Of course, there are always many reasons that markets move. The overriding correlation outlined in the attached articles between rule changes and regulatory changes since the U.S. began to open corporate debt markets using securitization, however, is both logical and unmistakable. Markets based on law and disclosure cannot operate efficiently when the rules and disclosure processes are left open to widespread hidden abuse and manipulation.

History has shown that reliance on the skills of men (even men of Mr. Greenspan's stature) will never be as efficient, over time, as free markets governed by sound law and policy. The Commission should, we submit, assume that there are valid reasons, founded in potentially disruptive requirements within the ABS proposal, that justified a negative market reaction to the release. What must be avoided is a failure to heed the lessons which this history teaches by failing to recover and correct critical errors.

By a separate comment letter, we point out several bases for concern (in addition to failure to address the Rule 2a-7 issues) that may underlie the market reaction following publication of the ABS proposal.

The largest single "spike" on Chart 12 began at turning point 11 and reversed at turning point 12. That "spike" is worthy of special analysis.

Nobel Laureate Milton Friedman explained the Great Depression as the product of a large decline in the U.S. money supply mistakenly engineered by the Fed. Others note that laws which effectively precluded financial asset sales or secured borrowings by solvent banks compounded a money supply contraction (and contributed to it) by forcing banks to stop making new, good loans because they could not rid themselves of old loans (good or bad). Defensively, banks

sought the liquidity of government obligations, even at ever-falling rates of interest, to assure funds to meet potential demands of depositors.

Whatever the true cause, it is generally agreed that a shrinkage of lending was associated with that historic debacle.

At page 16 of "Who Let the Bears Kill Goldilocks?", item 12 explains how a contraction of lending also accompanied the spread spike (and stock market decline) of 2002. Chart 13 is a chart from the April 15, 2003 *American Banker* (with comments added). It shows how a contraction of corporate lending, concentrated among 7 banks (now 5), may have generated the $1.9 trillion of losses investors suffered. That chart is the source for the commentary.

The final chart (Chart 14) retraces mortgage spreads from Chart 4. It also repeats the dates of the 20 turning points shown on Chart 12 and adds (in parentheses) the 8 points shown on Chart 4. Of the events contributing to 10 corporate spread "spikes" noted on Chart 12, only two (1998 and 2002) significantly affected both markets (mortgages and corporates). Two others (early 2000 and mid-2003) affected only mortgages. The other eight events contributing to spikes in corporate spread really only affected corporate debt markets.

Why?

Again, when one analyzes corresponding market factors, each of these differences follows from the nature of each particular disruption. The 1998 amendments to '40 Act Rule 2a-7 required major changes in the short-term funding support for both mortgage and corporate structured finance markets. Thus, both markets were impaired.

Short-term funding that can fluctuate in balance and rate, however, is far more significant to corporate lending than it is to mortgage lending. By the 2000 to 2001 period, new and adequate mortgage warehouse procedures appeared. It took more time for markets to become as efficient as one would like, but new structures appear to have insulated mortgage markets from shocks that hit corporate markets in late 2000 and in 2001.

As noted above, the spikes of early 2000 and the summer of 2003 were worse for mortgages than for corporate debt. In 2000 the spike correlates with a rise in interest rates that adversely affects loan prepayment assumptions. That affects mortgage markets more significantly because mortgages have longer terms. In the second case mortgage markets were hit because the 2003 problem related particularly to hedging activities of mortgage GSEs.

The FASB-related spikes of late 2000 and early 2001 had little to do with residential mortgage funding. The September 2000 FASB changes (red point 3) affected bank conduits that make corporate loans; the early 2001 FASB rule "glitches" (red point 5) related to commercial mortgages (an alternative to normal corporate loans) and later glitches (red point 7) related to bank credit-card funding (a concern for banks that make corporate loans).

Except for the summer mortgage spike of 2003, events of 2002-2004 have certainly calmed both the mortgage markets and corporate markets. The small "up ticks" in corporate markets, moreover, had little effect on (or relationship to) residential mortgage markets.

The most striking difference between Charts 12 and 14 is the impact of the events of 9-11-2001. Corporate markets, concentrated as they are among a handful of market makers, reacted swiftly and violently adversely, until GM's "Keep America Rolling" program kick-started a recovery (points 9 and 10 on Chart 12). Mortgage markets, with little or no concentration and little or no essential reliance on the bank conduits of select corporate debt market makers, virtually "yawned" and moved on (red points 9 and 10 on Chart 14).

This difference in market reaction, perhaps more than any other, establishes an imperative to open, diversify and support proliferation of sound structured finance vehicles to liquefy corporate debt. With proper procedures in place, no terrorist organization would ever again bring U.S. markets to a near standstill.

The nation owes a debt of gratitude to GM for its "Keep America Rolling" program. We also owe it to ourselves and to all future Americans to learn from these lessons and finally "free the free-enterprise system," as President Reagan envisioned, by creating fair, sound, open and truly competitive structured finance systems.

July 12, 2004

PRESERVING THE ESSENTIAL ROLE OF STRUCTURED FINANCE

EXHIBIT
(Charts for Empirical Supplement)

Chart 1:	**Changing Markets and Credit Conditions for Growth Firms**
Chart 2:	**Mortgage Spreads and Market Events—January 1963 to date**
Chart 3:	**Mortgage Spreads and Market Events—January 1988 to date**
Chart 4:	**Mortgage Spreads and Market Events—January 1998 to date**
Chart 5:	**Corporate Spreads: High Yield Minus 10+ Year High Grade (1987 to date)**
Chart 6:	**Comparison of Corporate Spreads to Bank Losses and "Fallen Angels" (January 1988 to date)**
Chart 7:	**Corporate Spreads and Major Rule Changes (1988 to date)**
Chart 8:	**Comparison of Corporate Spreads (Inverted) and Equity Prices (1988 through 1992)**
Chart 9:	**Comparison of Corporate Spreads (Inverted) and Equity Prices (1998 through 2004)**
Chart 10:	**Comparison of Corporate Spreads (Inverted) and Equity Prices (January 1993 – April 27, 1998)**
Chart 11:	**Comparison of Corporate Spreads and Mortgage Spreads (January 1988 to date)**
Chart 12:	**Events Correlated with Corporate Spreads and Loan Losses (1998-2004)**
Chart 13:	**Commercial Lending 9/30/01 and 9/30/02**
Chart 14:	**Mortgage Spreads and Events on Charts 4 and 12 (April 27, 1998 to date)**

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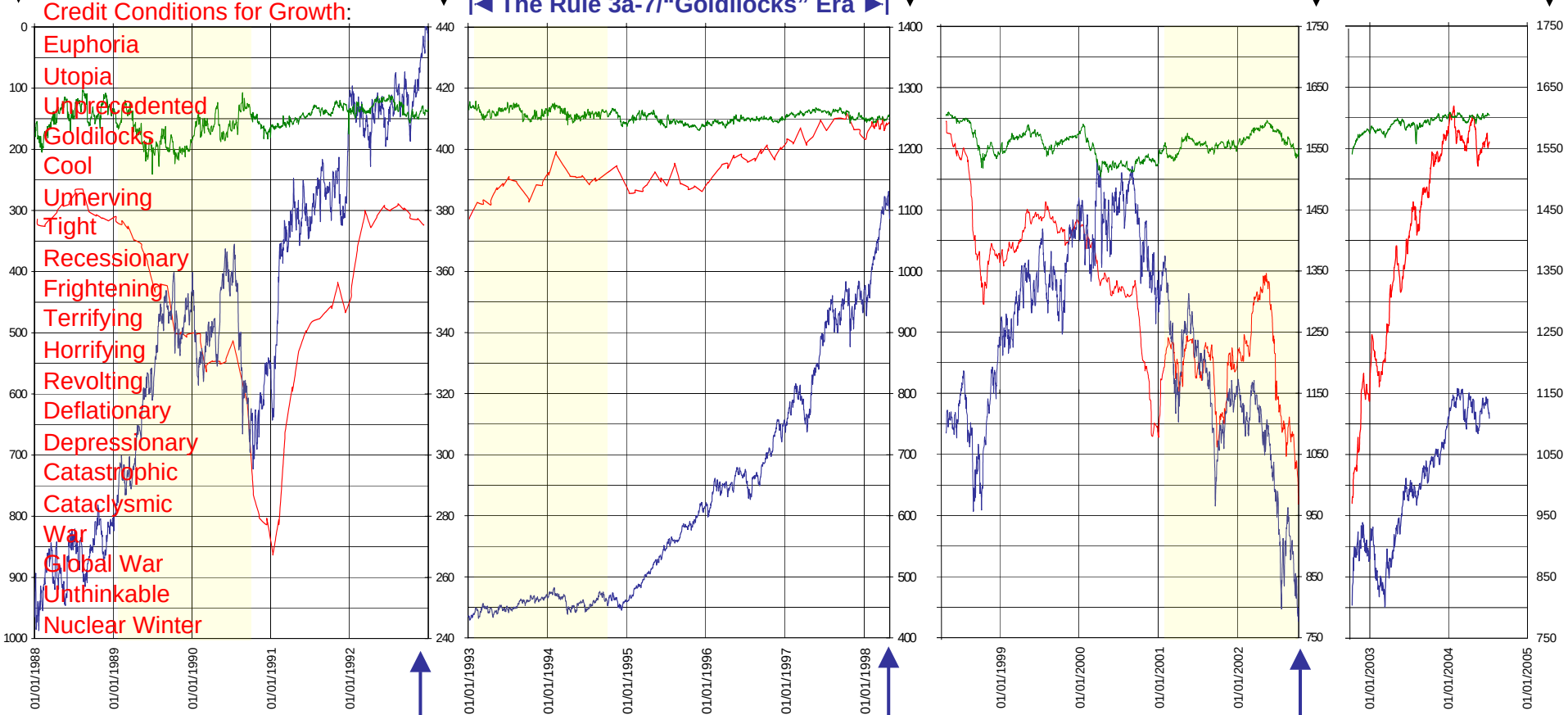
CHANGING MARKETS
AND CREDIT CONDITIONS FOR GROWTH FIRMS

CHART 1

RED: **High Yield Bonds minus AA-rated 10+ Year Bonds (in Basis Points--Source: The Wall Street Journal)**

GREEN: **LEHMTG Index minus 10-Yr. Treasurys (in Basis Points--Source: Lehman Bros.)**

BLUE: **S&P 500 Index**



January 1988 - December 1992

Rule 3a-7 enacted

January 1993 - April 27, 1998

Rule 2a-7 amendments take hold

April 27, 1998 - October 9, 2002

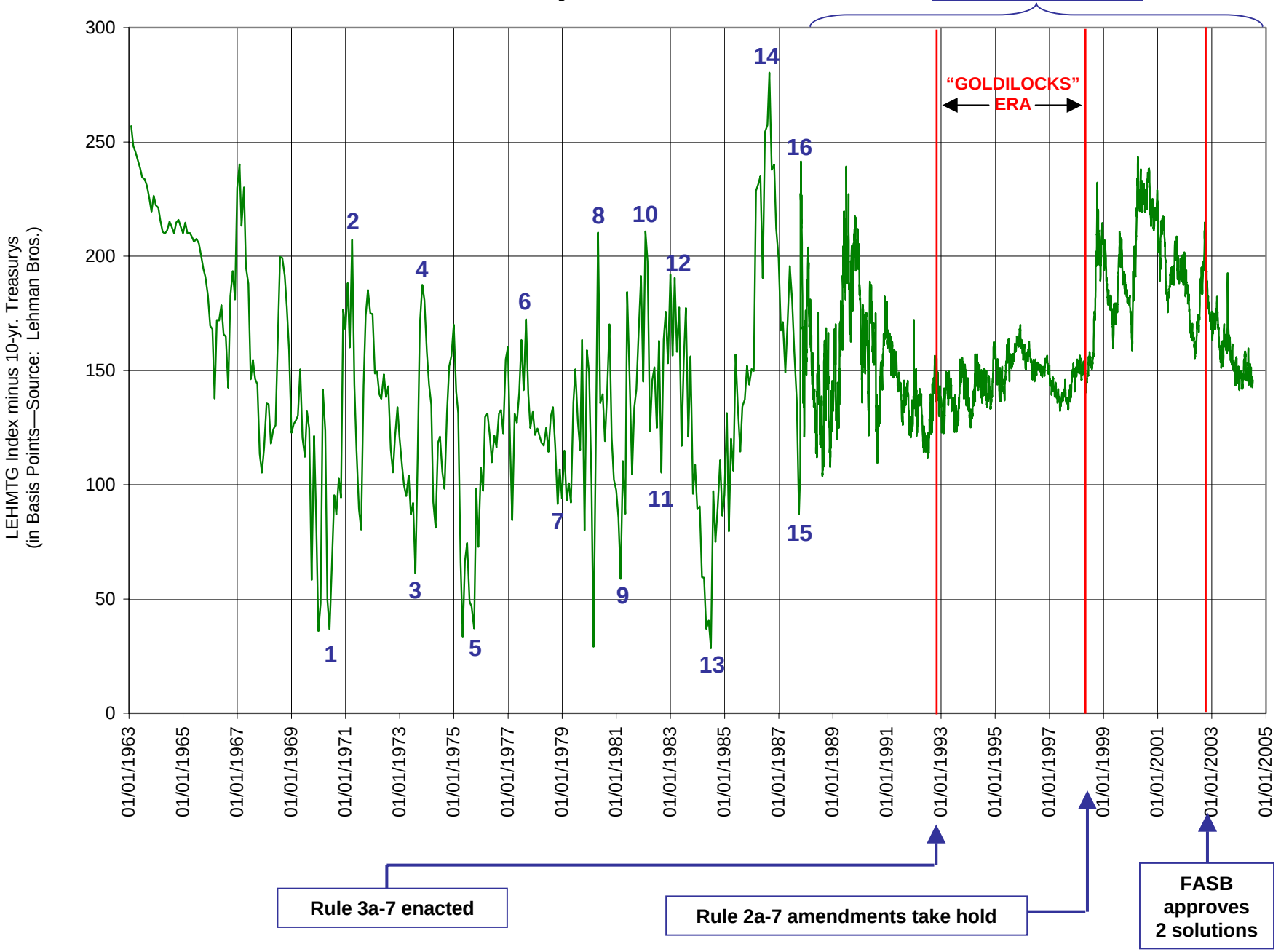
FASB approves 2 solutions

October 10, 2002 to date

MORTGAGE SPREADS AND MARKET EVENTS
January 1963 to date

(See Charts 3 and 4 for post-1987 events)

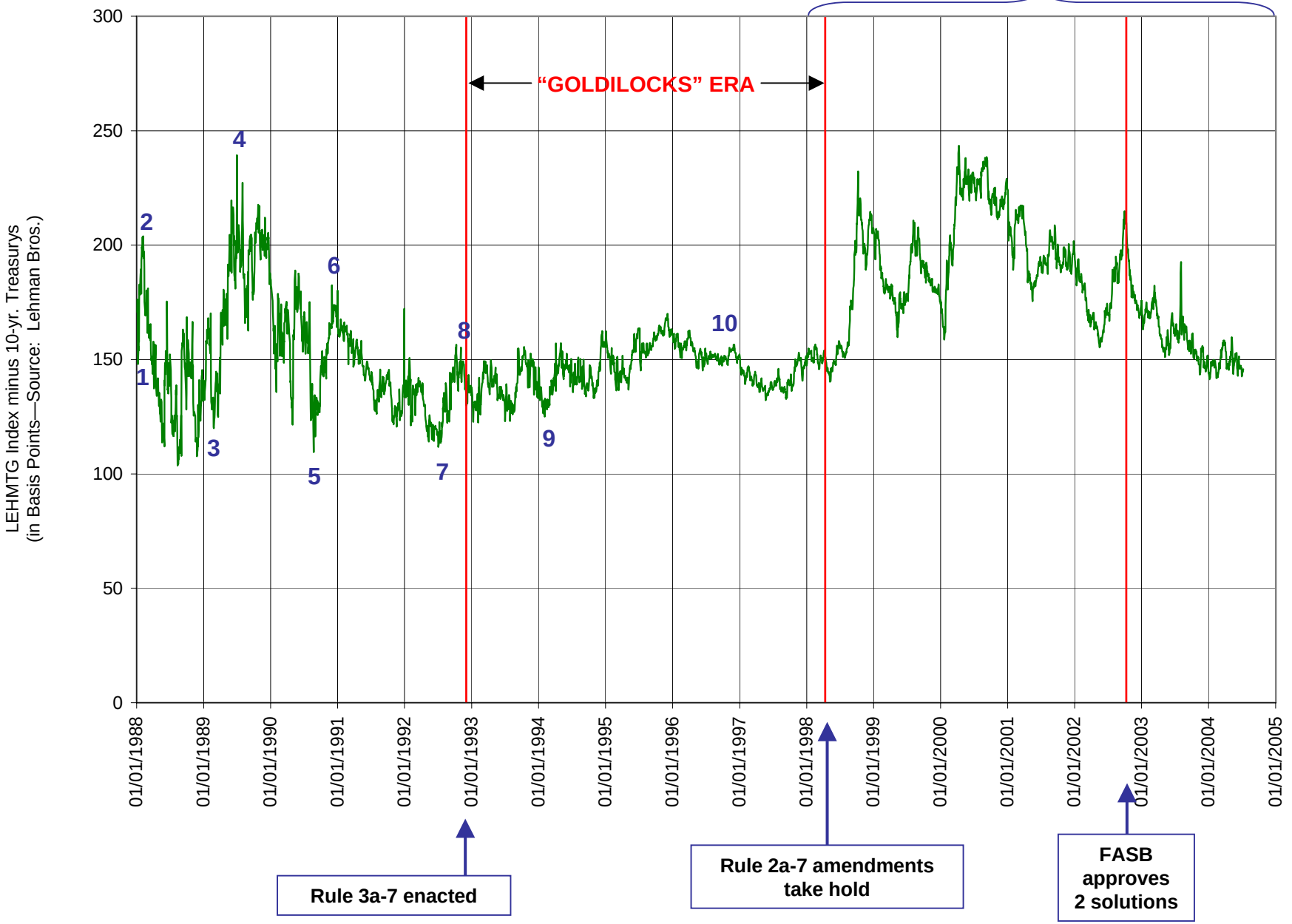
CHART 2



MORTGAGE SPREADS AND MARKET EVENTS
January 1988 to date

CHART 3

(See Chart 4 for post-1997 events)



MORTGAGE SPREADS AND MARKET EVENTS
January 1998 to date

CHART 4

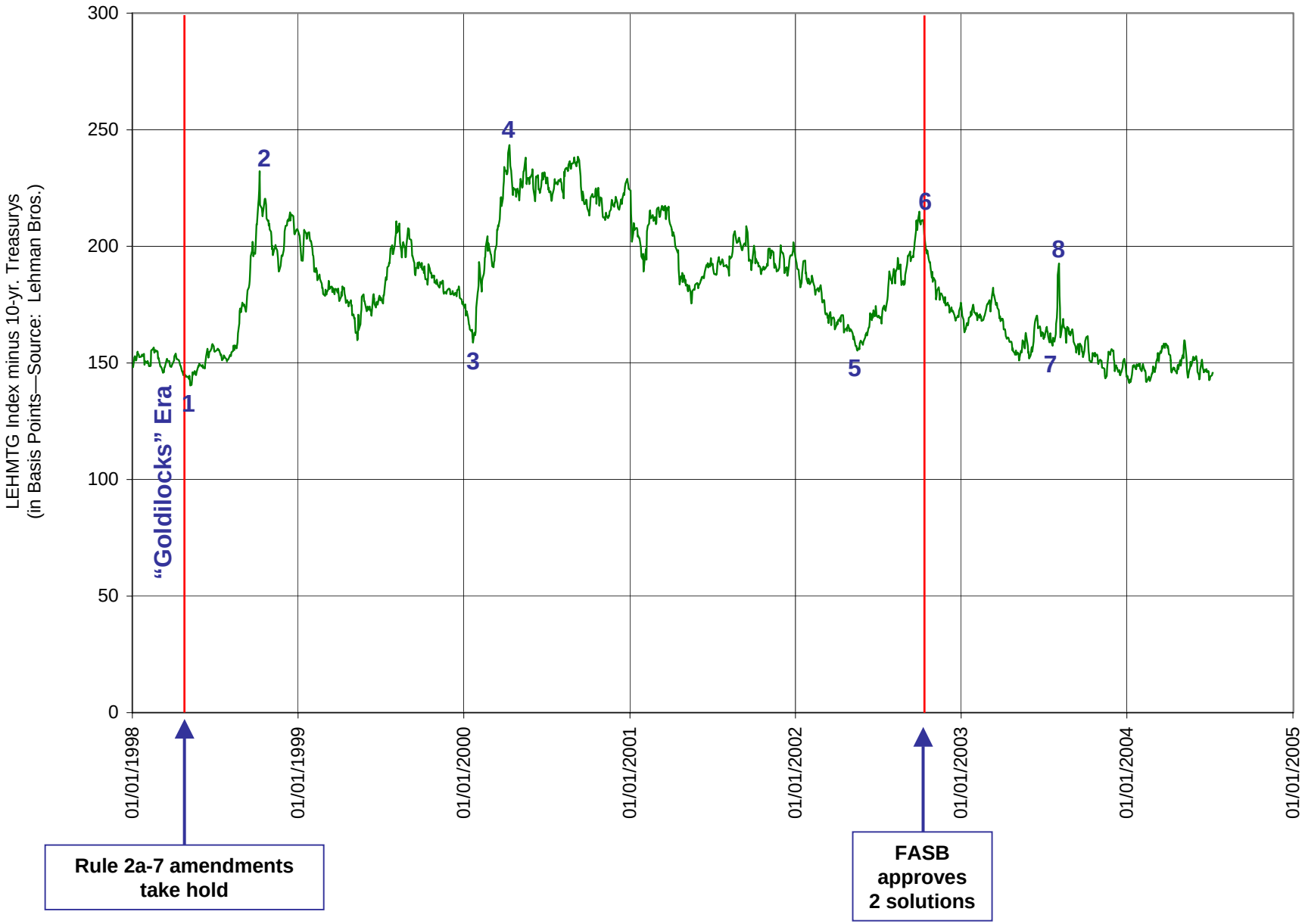


CHART 5

CORPORATE SPREADS: High Yield Minus 10+ Year High Grade

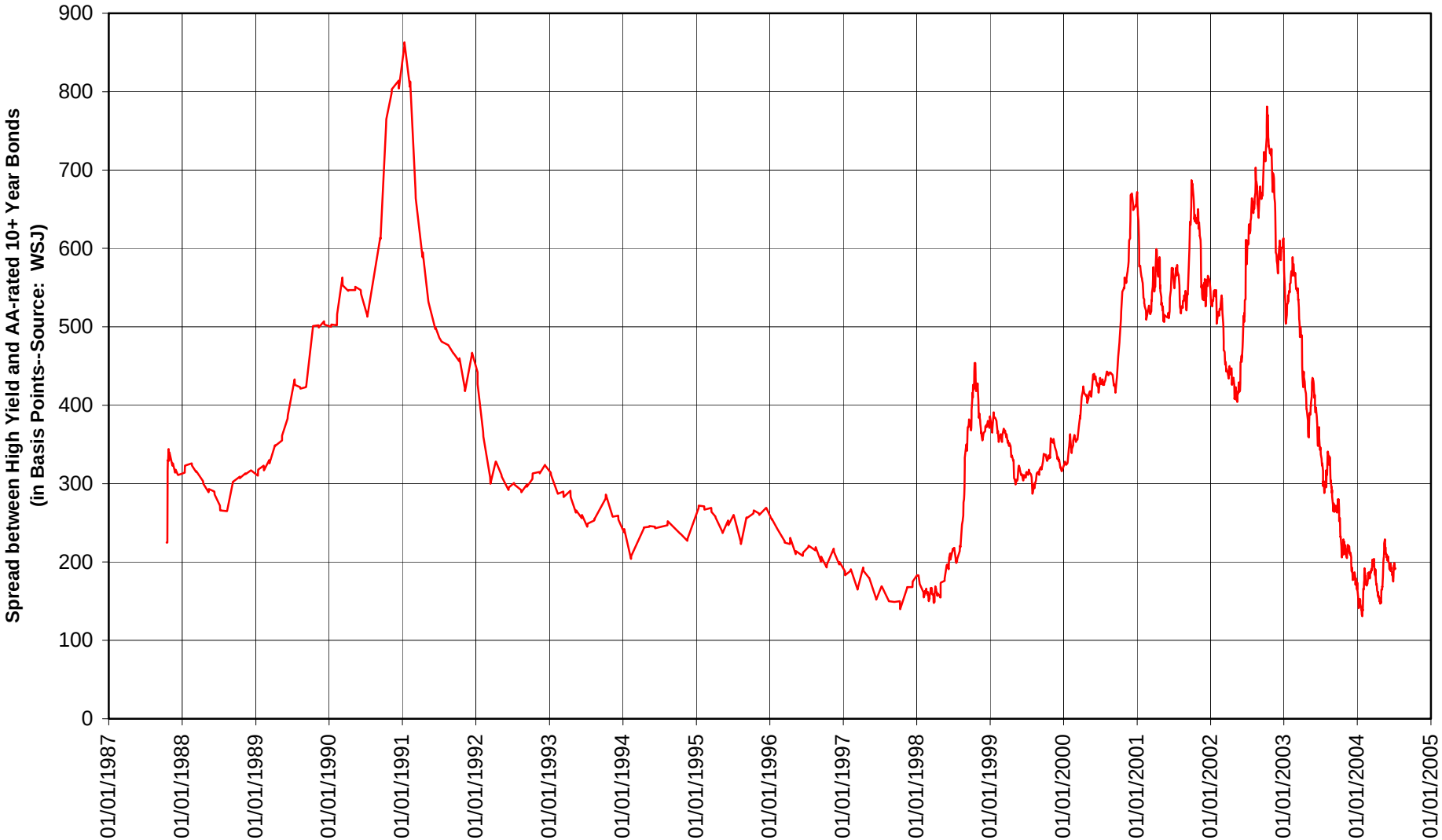
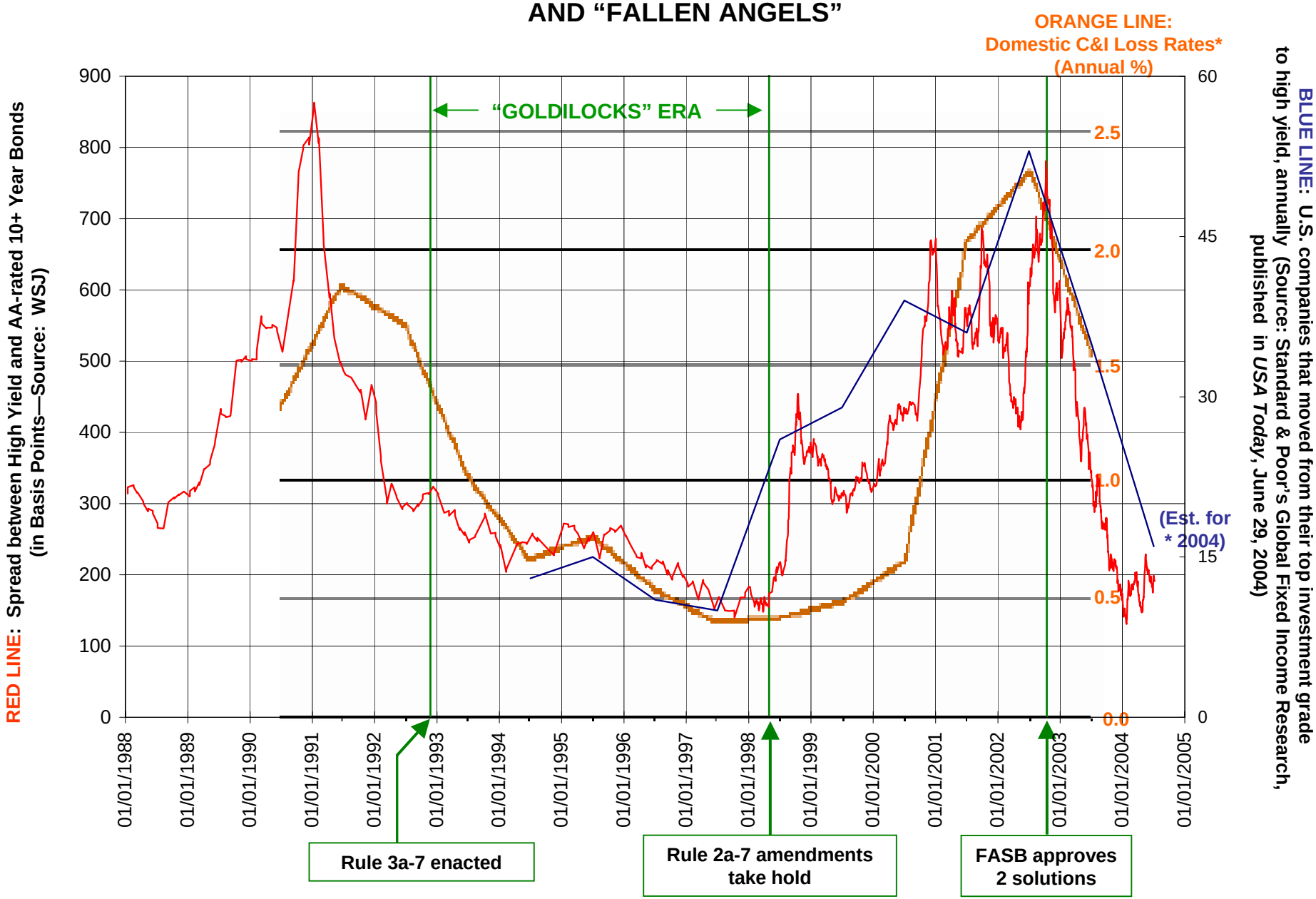


CHART 6

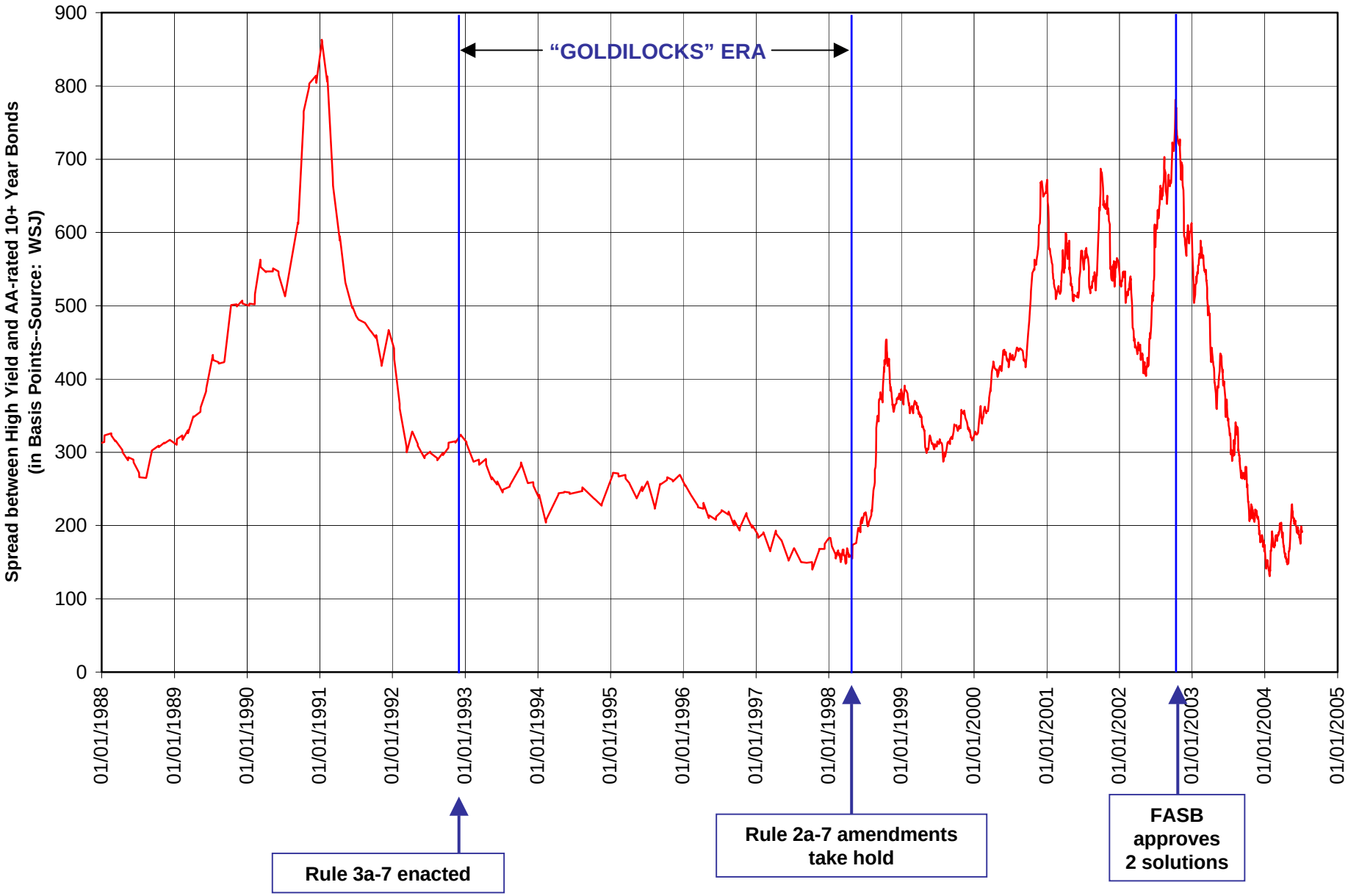
COMPARISON OF CORPORATE SPREADS TO BANK LOSSES AND "FALLEN ANGELS"



* (Source: Standard & Poor's Ratings Direct, *Research: The Dark Side of Bank Consolidation* by Tanya Azarchs, 5/27/04)

CHART 7

CORPORATE SPREADS AND MAJOR RULE CHANGES

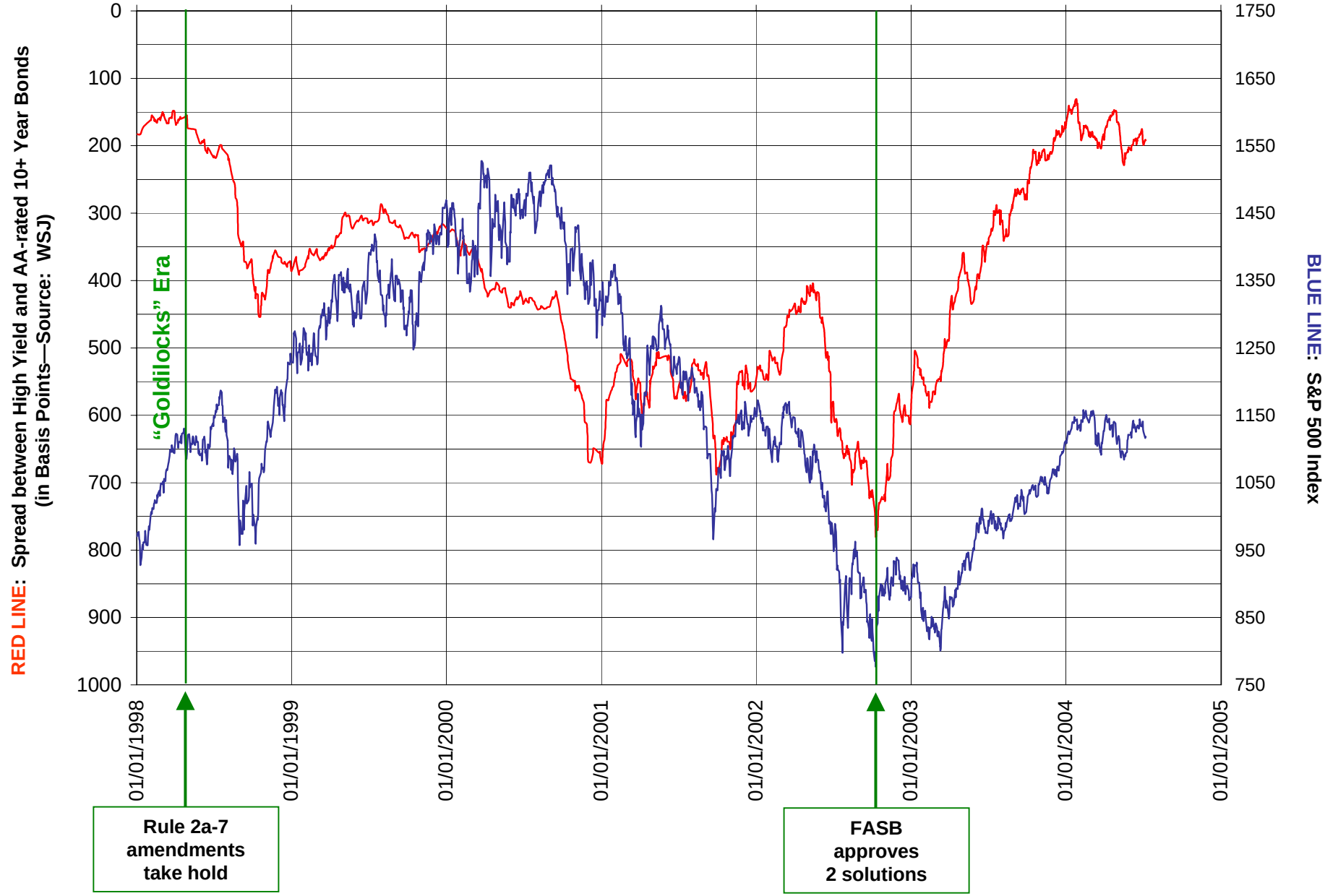


COMPARISON OF CORPORATE SPREADS (INVERTED) AND EQUITY PRICES 1988 through 1992

CHART 8

COMPARISON OF CORPORATE SPREADS (INVERTED) AND EQUITY PRICES 1998 through 2004

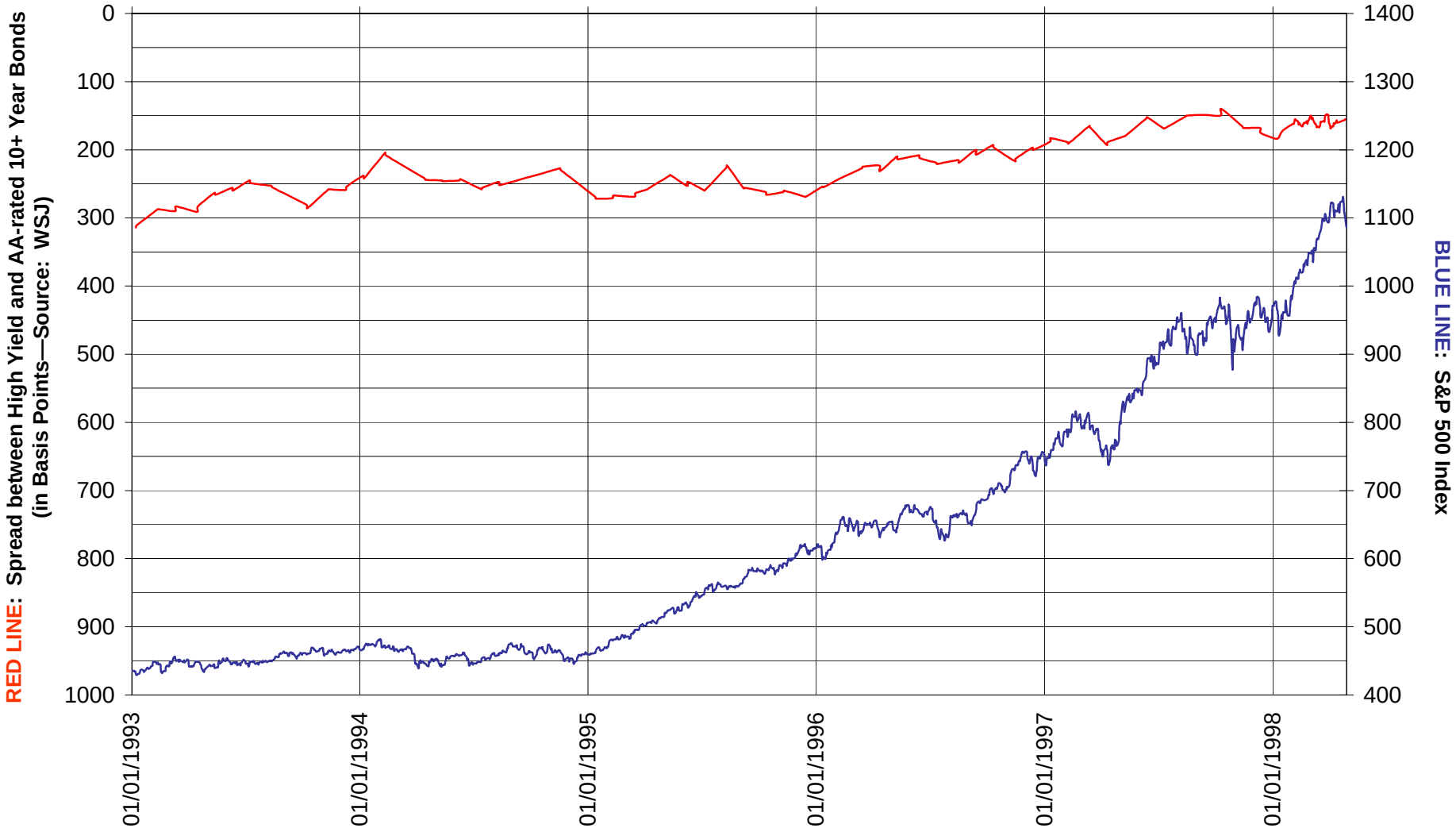
CHART 9



COMPARISON OF CORPORATE SPREADS (INVERTED) AND EQUITY PRICES
January 1993 – April 27, 1998

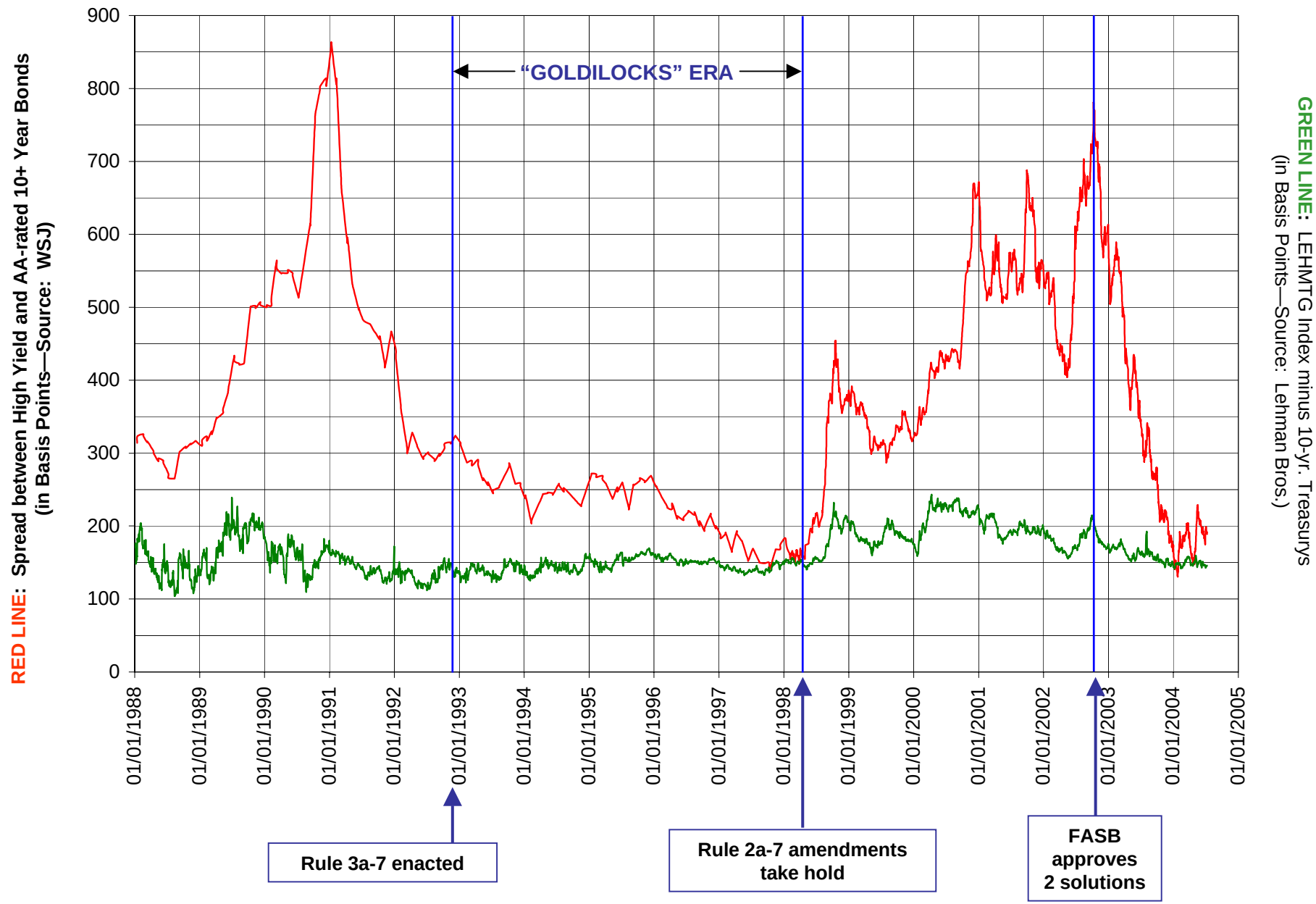
CHART 10

The "Goldilocks" Era



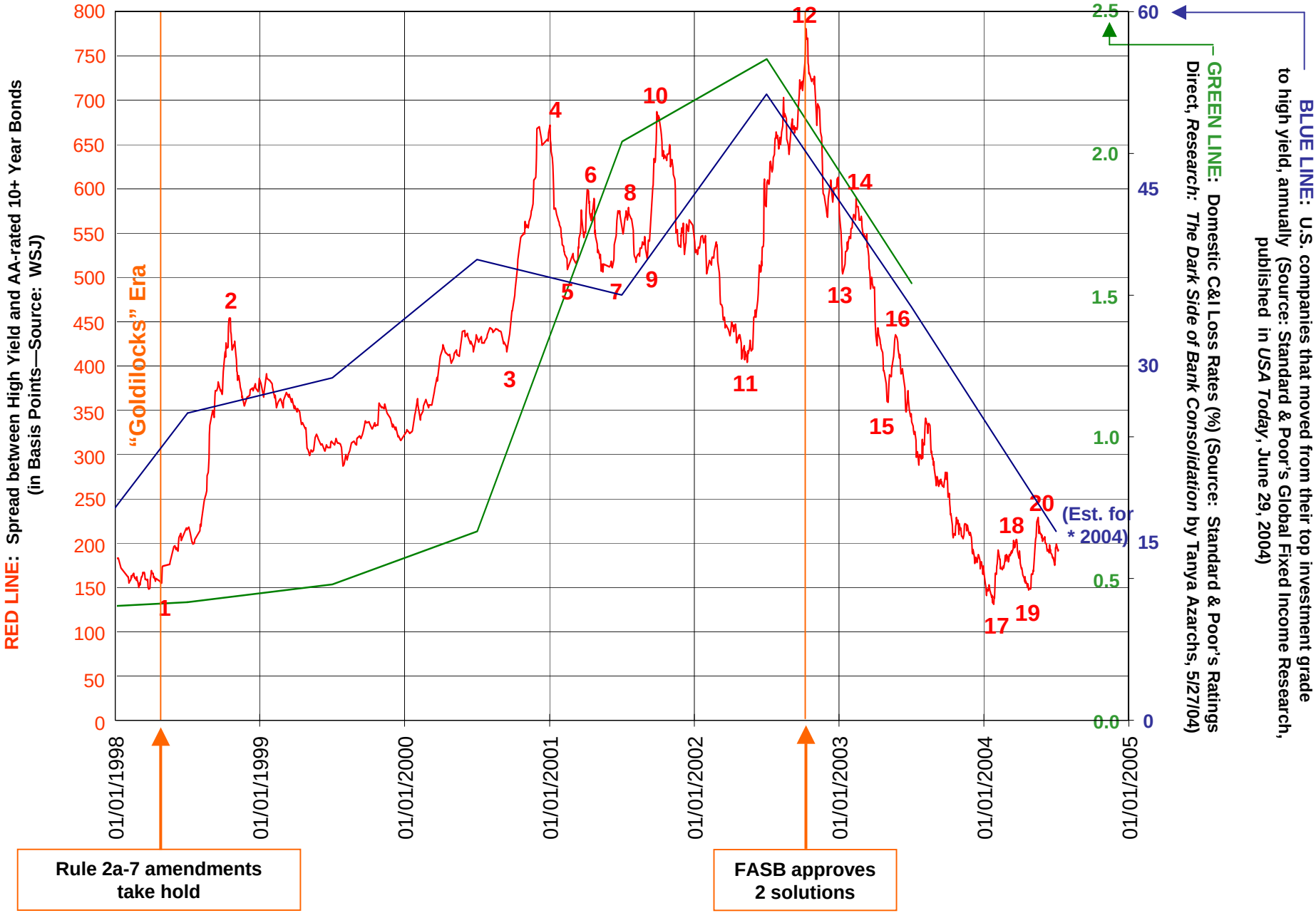
COMPARISON OF CORPORATE SPREADS AND MORTGAGE SPREADS
January 1988 to date

CHART 11



EVENTS CORRELATED WITH CORPORATE SPREADS AND LOAN LOSSES
1998-2004

CHART 12



COMMERCIAL LENDING 9/30/01 AND 9/30/02

CHART 13

TOP BANK AND THRIFT HOLDING COMPANIES IN COMMERCIAL AND INDUSTRIAL LOANS

On Sept. 30, 2002. Dollars in thousands

		Sept. '02	Year earlier	Change
1	**Bank of America Corp.** Charlotte	$72,971,000	$93,115,000	-21.63
2	**Wachovia Corp.** Charlotte	41,157,000	50,419,000	-18.37
3	**Wells Fargo & Co.** San Francisco	40,610,000	42,528,000	-4.51
** 4	**Bank One Corp.** Chicago	39,850,000	50,953,000	-21.79
*** 5	**FleetBoston Financial Corp.**	35,135,000	44,897,000	-21.74
6	**Citigroup Inc.** New York	34,419,000	41,966,000	-17.98
7	**J.P. Morgan Chase & Co.** New York	32,093,000	42,540,000	-24.56
8	**U.S. Bancorp** Minneapolis	30,713,000	35,855,000	-14.34
9	**SunTrust Banks Inc.** Atlanta	22,217,869	23,833,434	-6.78
10	**Comerica Inc.** Detroit	22,070,589	22,430,998	-1.61
11	**National City Corp.** Cleveland	18,276,489	19,450,045	-6.03
12	**KeyCorp** Cleveland	16,165,032	17,599,353	-8.15
13	**PNC Financial Services Group** Pittsburgh	13,315,378	15,805,279	-15.75
14	**Fifth Third Bancorp** Cincinnati	10,519,567	7,512,156	40.03
15	**SouthTrust Corp.** Birmingham, Ala.	8,126,814	7,260,936	11.93
16	**BB&T Corp.** Winston-Salem, N.C.	6,738,344	6,391,779	5.42
17	**Sovereign Bancorp Inc.*** Wyomissing, Pa.	5,723,794	5,208,153	9.90
18	**Marshall & Ilsley Corp.** Milwaukee	5,493,425	5,318,332	3.29
19	**Union Planters Corp.** Memphis	5,246,457	5,221,193	0.48
20	**Regions Financial Corp.** Birmingham, Ala.	5,174,590	4,837,466	6.97
21	**M&T Bank Corp.** Buffalo	4,846,945	4,863,029	-0.33
22	**Huntington Bancshares Inc.** Columbus, Ohio	4,307,291	5,196,333	-17.11
23	**Northern Trust Corp.** Chicago	4,262,002	5,059,838	-15.77
24	**AmSouth Bancorp.** Birmingham, Ala.	4,083,449	4,558,178	-10.41
25	**BancWest Corp.** Honolulu	3,955,019	2,363,356	67.35
	TOTALS	487,471,054	565,182,858	(2001 was 16% higher than 2002)

A concentrated contraction:

7 firms (now 5) accounted for 94.5% of the $77.7 billion total decline in balance sheet lending, with over 25% more C&I loans at 9/30/01 (despite 9/11) than at 9/30/02.

Note: Contractions in conduits and other structures are not reported, but could have been even larger.

*Sum of subsidiaries' data in call reports
**Merged with J.P. Morgan Chase & Co.
***Merged with Bank of America Corp.

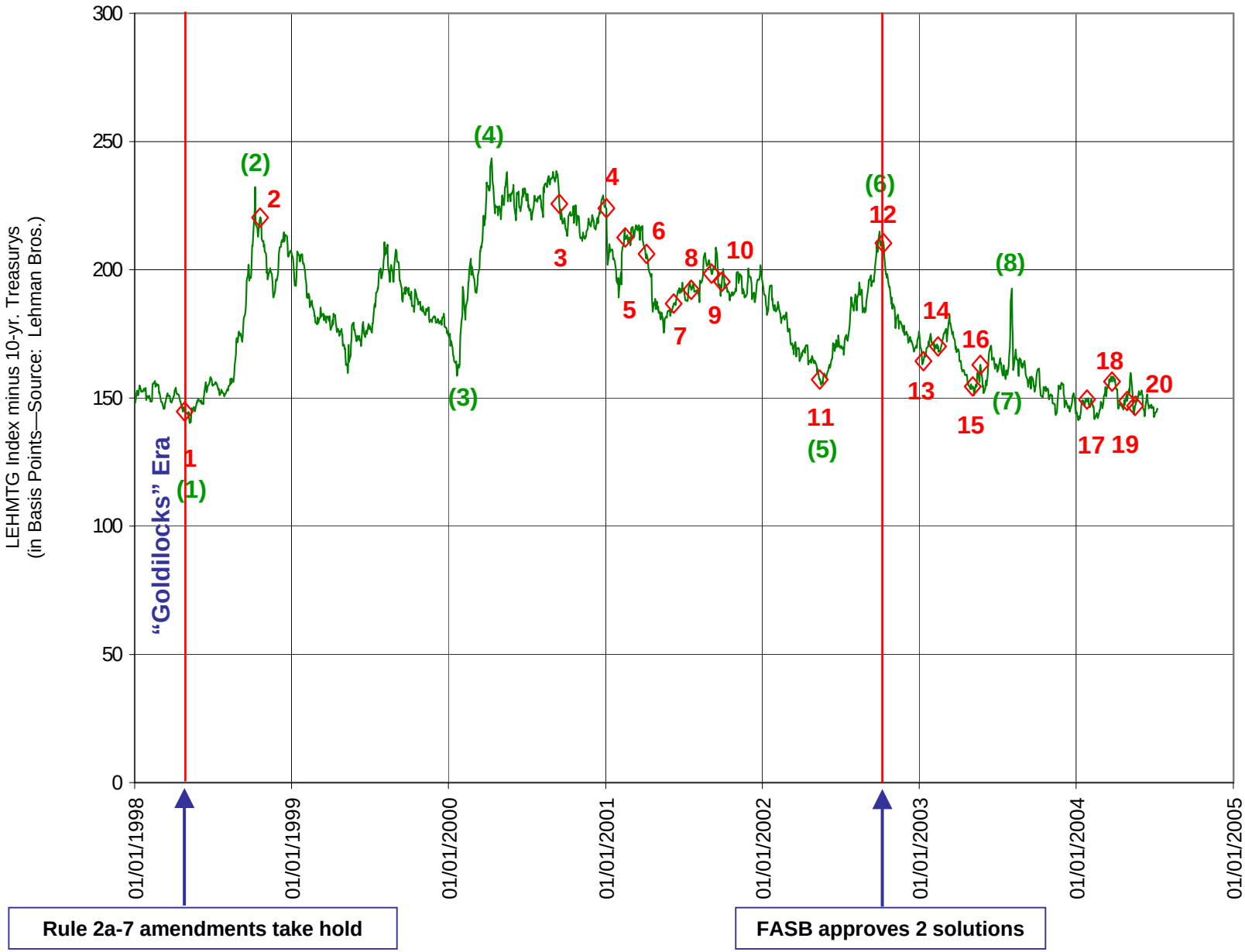
American Banker, Tuesday, April 15, 2003

Source: Sheshunoff Information Services, a division of Thomson Corp.

MORTGAGE SPREADS AND EVENTS ON CHARTS 4 AND 12
April 27, 1998 to date

CHART 14

Comparing changes in corporate spreads with changes in mortgage spreads



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FOLEY & LARDNER LLP

PRESERVING THE ESSENTIAL ROLE OF STRUCTURED FINANCE

Supplemental Articles and Bibliography

1. "Credit Monopolies Harm Lenders and Borrowers," *The 2004 Guide to Structured Finance* (supplement to *International Financial Law Review*), June 2004

2. "Ending Monopoly," The ISR Legal Guide to Securitisation, July 2004

3. "Barriers, Loopholes and the Jobless Recovery," International Briefings column of the *International Financial Law Review*, October 2003

4. "Who Let the Bears Kill Goldilocks?", published as Volume 23, Number 5 of the *Futures & Derivatives Law Report*, July/August, 2003

5. "The Suicide Monopoly," January 15, 2003.

6. "Magic Markets," March 2004

7. Bibliography of other articles

Frederick L. Feldkamp
Foley & Lardner LLP
July 12, 2004

Credit monopolies harm lenders and borrowers

Frederick Feldkamp of Foley & Lardner voices his views on the natural price of competition and how corporate credit monopolies are negatively affecting worldwide finance

The US is debating lots of things in this political year. There is, however, no debate that the economy still matters. In economics, there is no debate that more jobs are preferable to less jobs or that competition is preferable to monopoly. What is still debated is just *how* preferable the natural price of competition is over that established by a monopoly, and how achieving the natural price of a single commodity could overcome market instability, jobless recoveries and threats that terrorists pose to world markets.

Monopoly versus competition

The father of modern economics, Adam Smith, described the difference between monopoly and competition as follows:

"The price of monopoly is upon every occasion the highest which can be got. The natural price, or the price of free competition, on the contrary, is the lowest which can be taken, not upon every occasion indeed, but for any considerable time together. The one is upon every occasion the highest which can be squeezed out of the buyers, or which, it is supposed, they will consent to give: The other is the lowest which the sellers can commonly afford to take, and at the same time continue their business." Adam Smith, *The Wealth of Nations*, page 87.

Worse yet, monopoly is its own worst enemy. As a board game, Monopoly shows how pricing advantages, cycled time and again throughout the game, eventually permit one player to destroy all competitors.

But remember how Monopoly ends. Having no customers to use their property, the winner of Monopoly owns assets that produce nothing. So the winner is just as bankrupt as the losers.

However, this moral lesson of Monopoly is often lost on real-life players of the game.

Monopoly in action

Here are some graphs that contrast monopoly and natural pricing. Each tracks the price of a commodity over time.

Price trend 1 has all the earmarks of a monopoly, as Smith described it and as the game concludes. This commodity could be the price of silver as the Hunt brothers sought to corner the market. Once the market was cornered, they found no buyers when they decided (or were forced) to sell.

Price trend 2 shows Adam Smith's characteristics of competition. The trend line continuously seeks the natural price of this commodity as continuous productivity improvements lower the price "which the sellers can commonly afford to take, and at the same time continue their business." This trend could represent the price of personal computers.

Price trend 3 (next page) has the characteristics of an unruly oligopoly. This trend could represent the price of oil as OPEC nations establish cartel prices then promptly cheat, or as consumers become more efficient, creating a glut of oil that ultimately breaks the monopoly. This graph has been numbered to show 19 turning points in the price trend of this commodity. The odd numbers begin a rising price trend and represent events that enhance sellers' price controls. The even numbers represent events that reduce sellers' market control.

Are these turning points predictable? With one exception, a small group of experts correctly predicted each change of direction in the price of this commodity as the logical consequence of specific activities that occurred at the time of each turning point. That group advised *against* actions that coincided with the beginning of each spike (other than points 9 and 13) and encouraged actions that coincided with the reversal of every spike.

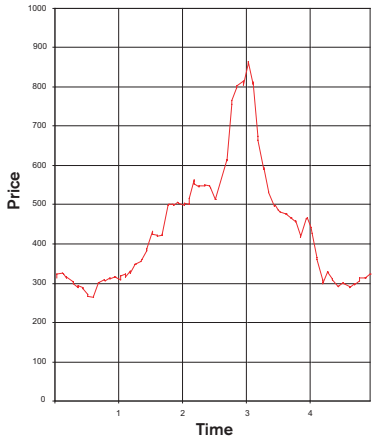
The last market-maker monopoly

Why are the turning points on price trend 3 so predictable?

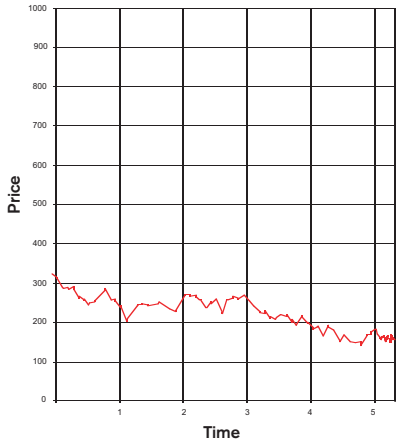
These three price trends are not the price of silver, computers or oil. They are all the price of the single most essential commodity in any free market economy: *corporate credit*. Specifically, these trends represent an index of the *net* price that growth companies pay for long-term monetary exchange in US debt markets. Price trend 1 is from January 1988 through December 31 1992. Price trend 2 is the so-called Goldilocks Economy, starting in 1993 and ending a few months into 1998. Price trend 3 is the calamitous corporate credit market observed from April 1998 until well into the recovery which began at point 12, October 9 2002. Price trend 3 ends May 25 2004.

The price on these graphs represents the net cost of long-term credit charged to growth (high-yield) firms because it charts the difference, in basis points, between what investors are paid on long-term bonds by large highly-rated institutions that provide long-term corporate credit and what is charged to growth firms for long-term debt. This is the net cost of exchange for debt capital that US firms use to leverage equity and

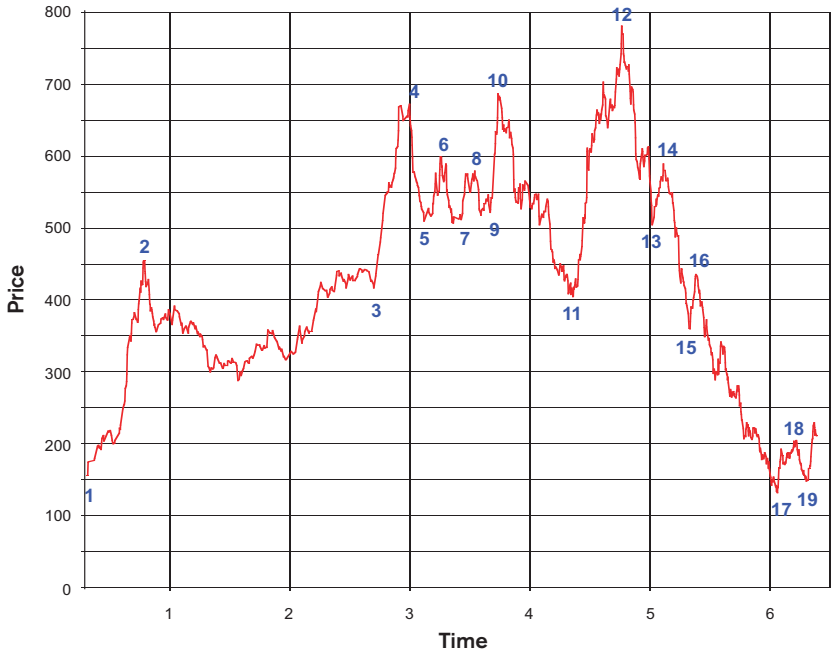
Price trend 1



Price trend 2



Price trend 3



grow. It's the difference between what monetary institutions pay for long-term money invested by the productive side of the economy and what the productive side pays the monetary side for leverage to grow.

A flexible market economy can adjust to vacillating prices for silver or oil through the application of supply and demand. However, without the availability of long-term leverage at prices that permit growth businesses to leverage capital and grow, the production of wealth is necessarily restrained. Each spike on price trends 1 and 3 represents a liquidity cost crisis, a credit famine that starves unprepared businesses and destroys economic value.

It is not proclaimed from the rooftops of New York, but there is no secret about the monopoly that controls the net price of credit. The Federal Reserve System influences the cost of credit to highly rated financial institutions through monetary policy, and it can influence bank lending policies, but it does not establish the price of corporate credit. In the spring of 2001, a friend and respected banker was lamenting the failure of the consolidated banking community's model for initial public offering (IPO) equity markets. When I asked how the future stacked up, he replied that he and his fellow bankers would have to concentrate on preserving their last monopoly, corporate credit.

He did not understand the enormous damage of that monopoly (even to those who seek its preservation) and why it must be ended, once and for all. Every market economy that has blundered into supporting a credit monopoly has eventually suffered huge market losses.

The ultimate systemic risk this monopoly poses, however, is not just a loss of US market value. This was painfully brought home by the one unpredicted adverse turning point on price trend 3 – September 11 2001 (point 9 on the chart).

On that date, concentration of the world's corporate debt market making among a handful of banks located within a few blocks of each other on a single island in the US made the world's economic health vulnerable to a small group of suicidal fanatics. While self-inflicted crises that began at points 1 (1998), 3 (2000) and 11 (2002) ended up causing more damage, the estimated wealth sacrificed in the spike after September 11 2001 was roughly $1.5 trillion. If that spike had not been reversed by actions outside the financial markets, the damage could have been *much* worse.

The system only began to recover from the effects of September 11 2001 when the US automotive industry insisted that terrorists must not be allowed to abuse the US's weaknesses. Turning point 10 coincides with the introduction of GM's "Keep America Rolling" programme of 0% financing.

Re-creating the level and stability of price trend 2 is the key to ending credit famine and regaining sustained growth. That can be achieved by diversifying the sources and support for corporate credit. All that is required is the removal of loopholes and barriers that give certain market participants a competitive advantage. The US knows how to do that, yet it has fumbled and blundered at getting this job done since 1998.

Government: the only source of a credit monopoly

Debt markets are creatures of law. Adam Smith's England was subjected to a credit monopoly by an Act of Parliament in 1695. The American Revolution can, in part, be traced to that mistake. More recently, the US began to suffer from a credit monopoly almost immediately after bank regulators decided (in 1989, contrary to the advice of other groups) that it was necessary to permit a few well-capitalized banks to fund corporate lending from nominees that each such bank both managed and fully guaranteed, but did not report on-balance-sheet (single-obligor multi-seller conduits sponsored by a few trusted banks, or Bank Conduits).

Without government support, monopoly of credit is economically infeasible. With such support, its effects are utterly predictable. The spike on price trend 1 and 17 of the 19 turning points on price trend 3 are explained by reference to market rules, and specific actions, that either enhanced or reduced the credit market control that the use of off-balance-sheet Bank Conduits gave a handful of banks. (Turning points before June 2003 are explained in "Who Let the Bears Kill Goldilocks?" by Frederick L Feldkamp, *Futures & Derivatives Law Report*, July/August 2003, Vol 23, No 5.)

Creation of these straw-man nominees was, perhaps, necessary. In 1989, the US was preparing to close 1,400 insolvent US banks and thrifts and impose capital rules on all depositary institutions. Regulators were justifiably concerned that the closures and new capital requirements (imposed to prevent a repeat of the so-called S&L crisis) would cut off liquidity to worthy corporate customers.

A truly diversified pool of well-secured business loans only suffers loss when lenders blunder. One large long-lived

pool of such loans has operated with $0 losses on its *defaulted* loans for nearly 90 years. Such pools do not require capital, perhaps, but they do need to be reported on balance sheet so that creditors and shareholders can evaluate the leverage that managers of the entity are undertaking. Also, if the loans in a pool are truly diverse and well secured, the cost of capital applied to support them will be more than offset by reduced leverage costs to the bank that sponsors that pool.

Thus, arguments about capital and disclosure, which have hampered efforts to compel proper reporting of Bank Conduits, are really only arguments about whether bank management must disclose its leverage and potential lending errors to creditors, shareholders and regulators, using financial statements that fairly present the investments and leverage to which the bank is exposed. Regulators can adjust capital rules to fit the true risk profiles of reported loans.

By 1990, the Bank Conduit solution to liquidity led to a corporate cost-of-liquidity crisis. As the US closed thrifts, it avoided a crisis in residential mortgage lending without creating a similar monopoly. That was achieved by the use of well-developed mortgage securities. Securitization solutions that had been developing since 1970 for residential mortgage markets, however, could not create competition or liquidity for corporate debt markets due to limitations under Securities and Exchange Commission (SEC) registration rules and the Investment Company Act of 1940 (the 1940 Act).

Thus, regulators' 1989 concerns that corporate credit might suffer more than other types of credit were reasonable. The better long-term solution would have been to relax restrictions on securitizing corporate debt, but that might not have been adequate to address immediate corporate credit needs. Unfortunately, the credit famine spike in funding costs shown on price trend 1 began almost as soon as Bank Conduits became the accepted tools to foster low-cost corporate liquidity. The spike coincided with Iraq's invasion of Kuwait and is often blamed on oil market fears. The recovery in spread coincided with expelling Iraq from Kuwait.

Not every US growth company would fail if Iraq seized Kuwait's oil. Oil would still be sold and almost everyone would be affected by an oil price rise, not just growth firms. The rising spread that starved growth companies in 1990, therefore, did not accurately reflect credit risk, but it did create risk. *Every* borrower that is charged nearly 9% more for funds than its high-grade entrenched competitors will eventually fail. The spike of 1990 made the banks' perceptions of greater risk a self-fulfilling prophecy.

The free world expelled Iraq from Kuwait, but the US economy suffered as corporations could not relieve their debt burdens quickly enough. Firms continued to suffer from that spike in funding cost until well into 1993. In 1992, a US president who helped push Iraq from Kuwait, and bravely saved the nation's financial health by closing its insolvent Zombie thrifts, could not generate an economic recovery quickly enough to receive a second term.

The Goldilocks Economy

To that administration's lasting credit, while losing the 1992 election, the SEC enacted Rule 3a-7 under the 1940 Act (November 1992). That rule eliminated the 1940 Act legal barrier to efficient securitization of corporate debt. Along with new shelf registration rules, Rule 3a-7 opened new paths for non-bank competition with Bank Conduits. President Bush's team laid the foundation for the competitive natural pricing of corporate debt during the Goldilocks Economy (price trend 2). The virtuous cycle fostered in 1992 did not end until the SEC's 1998 rules created a monopoly *and* monopsony for Bank Conduits.

Without government support, monopoly of credit is economically infeasible. With such support, its effects are utterly predictable

Competition did not prevent Bank Conduits from growing between 1992 and 1998, but it created the means by which competition could prevent liquidity starvation by controlling spikes in the effective net price of credit. The new rules permitted highly efficient riskless arbitrage transactions by stand-alone non-bank competitors using corporate debt to support the securities they sold. Those transactions became profitable whenever the net price of credit rose to a point where corporate debt forms of collateralized mortgage obligations (CMOs) could be done profitably at a natural exchange cost. So Rule 3a-7 created a market dominated by the natural price of competition, cutting off the monopoly pricing power of Bank Conduits without cutting off their ability to fund credits competitively.

These arbitrage transactions assured that demand for high-yield debt would rise along with a rising supply of high-grade debt (reducing spreads) whenever pricing increased spread. Directing greed to a virtuous purpose prevented credit famines. As techniques for riskless arbitrage improved, the natural competitive price of credit fell, lowering the cost of growth, as shown on price trend 2. Once growth firms gained the confidence to increase leverage, the economy (and US equity markets) rose appropriately.

The calamity of 1998 to 2002

Price trend 3 shows the combined effects of off-balance-sheet Bank Conduits and amendments to the SEC's 1940 Act Rule 2a-7 that were enacted in 1998. The first tragedy of this period was the hedge fund crisis of 1998. To escape the consequences of that 1998 spike, moreover, a number of highly rated firms resorted to much the same gimmicks that had been allowed for a few banks nearly a decade earlier, while hoping for quick relief from credit starvation.

The Rule 2a-7 amendments of 1998 began as a response to events in 1994. They were materially revised from the SEC's initial proposal, however, at least partly as a result of efforts by lawyers working with Bank Conduits. The result was virtual elimination of the competitive structures for corporate debt intermediation that had assured a natural price of credit during the Goldilocks Economy.

The impact of those 1998 amendments was first felt in April 1998, as money market funds sent letters to conduits seeking disclosure of 10% obligors. As holders learned that disclosure of such investments would lead to a funding cut-off, affected positions had to be sold and the cost of debt exchange began to rise

immediately. Many of the positions that had to be sold were securities created in the riskless arbitrage transactions discussed above. Within months, competition for Bank Conduits was gone and a fire sale of corporate debt created the hedge fund liquidity famine of 1998.

That crisis ended when the SEC grandfathered existing securities in autumn 1998. The price of credit fell immediately as investors bought back what had been sold, and at lower prices. The SEC staff did all it could once it saw the problem, but grandfathering could not bring relief for more than a couple of years, because older securities would mature and new issues were not exempt.

Facing credit starvation, normally honest and conservative businessmen sometimes become prone to cheat. They assume an ability to cover when things return to normal. Follow-up funding crises in 2000, 2001 and 2002 exposed this cheating in amounts US markets had not seen in decades.

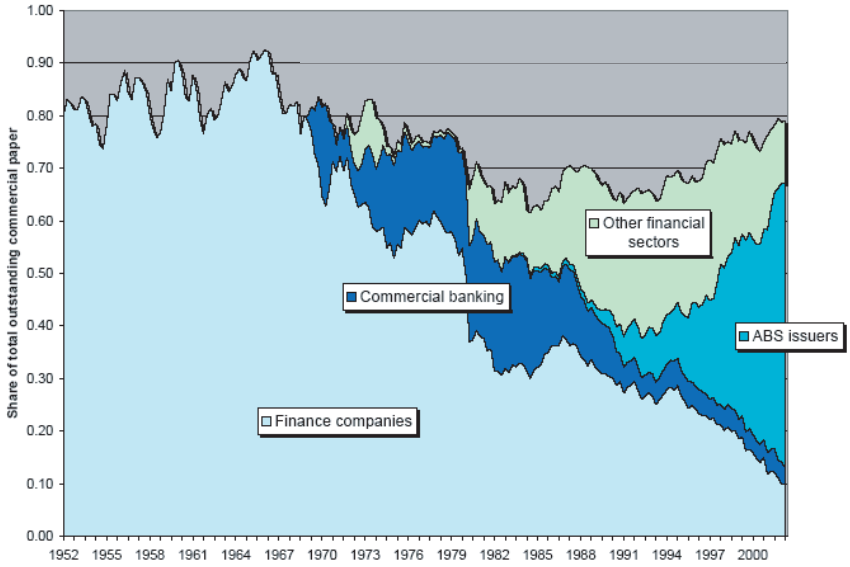
All this adversity can be related, in whole or in part, to the monopoly pricing powers gained by Bank Conduits over credit markets and the equally corrosive monopsony power Bank Conduit sponsors gained over money market funds. As a result of flaws negotiated on behalf of Bank Conduits into terms of the 1998 amendments to 1940 Act Rule 2a-7, diversified asset-backed security (ABS) structures that had neutralized the pricing power of Bank Conduits between 1992 and 1998 were cut off. In addition, despite rules intended to prevent credit concentrations at money market funds, the 1998 rules allowed a single sponsoring bank to be the *sole* source of credit deficiency support behind 100% of all assets of all money market funds, merely by creating enough nominee Bank Conduits.

The damage from high exchange cost reached near-record levels by 2002, forcing many firms, including cheaters, into bankruptcy. By October 2002, the cumulative damage since 1998 was a loss of roughly $3.4 trillion in equity value (actual and implied), and a much higher loss in growth opportunities.

Market domination

Armed with a monopoly on efficient access to money market funds and the ability to become the sole supplier of money market fund assets (a monopsony), it is understandable why Bank Conduits dominate short-term commercial paper (CP) issuance in US financial markets today. This is shown by the accompanying chart, copied from a recent Federal Deposit Insurance Corporation (FDIC) report, *The Evolving Role of Commercial Banks in US Credit Markets*, a Future of Banking Study, by Katherine Samolyk, March 25 2004. It is labelled Figure 9.

Figure 9. Commercial paper owed by financial sectors



This chart allocates CP owed by financial sectors among various types of issuers. The growth of ABS issuers since 1988 is simply astonishing. And a large part of this growth comes after the Rule 2a-7 amendments of 1998, when it became difficult for ABS issuers other than Bank Conduits to create CP that money market funds would purchase. The FDIC report offers no data with which to break down ABS issuers by type. Independent sources indicate that most of CP shown as owed by ABS issuers is owed by single-obligor multi-seller Bank Conduits. ABS issuers may also include some arbitrage issuers supported by other highly rated entities and a few remaining diversified obligor QSPE Conduits, which rely exclusively on non-sponsor support and can create the riskless arbitrages that contain the pricing power of Bank Conduits (but after 1998 those became rare).

The growth of ABS issuers was not harmful to credit prices during the Goldilocks Economy of price trend 2 because competition constrained the market power of Bank Conduits. In each other period, however, the structure of Bank Conduits allowed a select group of institutions to use gimmicks to hide enormous growth of their effective liabilities from shareholder and regulator scrutiny, and to combine disclosure lapses with capital advantages to stealthfully dominate corporate credit, to the great detriment of everyone (including themselves).

For those who understand how these nominees operate, the CP of Bank Conduits is simply disguised debt of the related bank sponsor. For those that do not understand how Bank Conduits are managed and supported, please see "Removing the 'D' from off-balance sheet – FIN 46 and Statement 140" by Frederick L Feldkamp, *IFLR Structured Finance Yearbook 2003*.

The solution

Since 2000, it has been learned that, to control Bank Conduits, their assets and liabilities must be reflected on the balance sheets of their related sponsors. Otherwise, the leverage that the equity of bank shareholders supports will remain hidden from them, precluding meaningful shareholder control.

In October 2002 the Financial Accounting Standards Board (FASB) voted to assure transparency of Gaap by consolidating single-obligor Bank Conduits. The FASB also voted to allow competition for Bank Conduits from diversified support conduits (QSPE Conduits). That made competition appear to be just beyond the horizon. Potential competition predictably triggered an historic market rally.

Without completing that reform process, however, as outlined in the 2003 IFLR article cited above, monopoly control of pricing will return (as may be occurring in 2004).

The structure of Bank Conduits has also contributed to the crisis in non-bank accounting. Once single-obligor Bank Conduits were accepted as off-balance-sheet entities by the SEC and FASB, how could anyone say only a few banks that were unquestionably honest and conservative can use those structures? So other firms mimicked the Bank Conduit structure, allowing them to retain all liability yet hide assets and debt. That exposed investors to Enron, Parmalat and many other scandals.

It is not proclaimed from the rooftops of New York, but there is no secret about the monopoly that controls the net price of credit

Eventually, as regulatory and management talent was diverted by the veil of Bank Conduit independence, credit quality review at some Bank Conduits fell. Sponsors have, therefore, at enormous cost, bought back Enron, Parmalat and other loss exposures that they had placed in their off-balance-sheet nominees. Disclosure of one bank's buyout of Parmalat exposure (which coincided with turning point 18 on price trend 3) further solidified the need for consolidation of single-obligor Bank Conduits.

Market practice seemed (until recently) to be forcing on-balance-sheet reporting and other reforms. Since October 2002, markets have responded favourably to each advance toward reform and adversely to each retreat. Several large institutions have decided that any careful analysis of single-obligor Bank Conduits mandates disclosure as a matter of fairness to shareholders (most notably, Bank One). The job must be finished, however, to assure the market stability that will foster sustained growth into the future.

So, what's the problem? Each loss is someone's gain

The gimmicks that allow this monopoly of corporate credit may represent the single most damaging economic mistake that the US has brought upon itself since the Great Depression. When several factors are combined, this mistake has denied US markets around $10 trillion of potential wealth. Like the 18th century monetary practices of England, which helped foster the US's colonial revolt, off-balance-sheet abuses have ceded market-making control over the net price of money used to generate growth to a handful of people within a few banks, to everyone's detriment.

How can monopoly pricing of monetary exchange damage everyone? Surely, it is observed, someone benefits to offset the loss.

Good economists commonly understand the destructive power of a spike in spread. When he was asked about a chart showing the spike that occurred in the last quarter of 2000, an economic adviser to then-incoming President George W Bush called it the scariest thing he'd ever seen.

The difference between the high cost points on price trend 1 and the low point of price trend 2 represents the difference between destructive leverage that eventually bankrupts all debtors and constructive leverage that accelerates the growth of capital. Each basis point reduction represents about $10 billion in equity value (based on saved interest expense and a 20-1 price/earnings multiplier). With favourable leverage, equity savings soon compound, as occurred about halfway into price trend 2 (the Goldilocks Economy). In aggregate, the loss of market value (and prospective wealth) for US households is simply staggering.

Spreads that reflect individual credit risks are, of course, essential for sound investment. Spreads that exceed individual credit risks, however, produce only harm (and no benefit). They are a self-defeating effort to shift market risk to one side of the debt contract. That starves borrowers, destroying the value of lenders' assets.

When all the instruments that financial clients invent and employ are boiled down, their sole purpose is to serve as a "great wheel of circulation" for "the goods which are circulated by it," to use words of Adam Smith. Whatever is lost in that "wheel of circulation" cannot possibly be recovered by those sectors that produce goods and services.

Smith observed:

"The revenue of the society consists altogether in those goods [it produces] and not in the wheel which circulates them. In computing either the gross or [net] revenue of any society, we must always, from their whole annual circulation of money and goods, deduct the whole value of the money, of which not a single farthing can ever make any part of either."

Any gain of monetary institutions by generally high and unstable spreads is compounded by their customers' leverage, so interest earned is more than offset by loss on the productive side of the economy. All of that loss, in turn, must be reflected in the need for increasing loss reserves of monetary institutions.

Smith said: "[E]very saving in the expense of erecting and supporting those machines, which does not diminish the productive powers of labour, is an improvement of the [net] revenue of the society; so every saving in the expense of collecting and supporting that part of the circulating capital which consists in money, is an improvement of exactly the same kind." Any interest cost that is greater than the natural competitive price of exchange creates a non-recoverable loss to society and, therefore, any reduction to the natural price benefits all sectors of society.

By monopoly pricing of credit, therefore, there are only losers.

The price trend charts, moreover, represent the difference between what major institutions pay for long-term funds and what the market charges growth firms for funds to leverage and grow. It is both the exchange cost of growth in the US and the hurdle that growth firms must overcome to compete with older, established firms.

Because growth firms produce jobs while established firms often seek to trim staff (to become more productive), when these three charts are put in order, the spikes shown represent a primary reason for the jobless recovery in the US. What responsible corporations can trust the system enough to borrow and grow after six years of periodic credit starvation?

With some assurance of reform, and a

Author biography

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Fred Feldkamp is a partner of Foley & Lardner LLP, heading the firm's Asset Securitization Practice. In 1973, Mr Feldkamp provided the legal basis for Foley & Lardner's pioneering bankruptcy opinion that permitted issuance of America's first rated private mortgage-backed security in the post-Depression era. Throughout the years, he has provided creative legal advice to support numerous securitization innovations:

- Creation of the largest foreign-owned Japanese mortgage service firm, through sponsorship of the largest non-bank financial-institution reorganization in Japan (2000);
- Utility transition securities (including the largest ABS offering of 1998);
- The first private collateralized mortgage obligation (1983);
- Exemptive proceedings permitting the first:
  - grandfathering under Rule 2a-7
  - home loan conduit
  - partial pool CMO
  - builder-bond conduit
  - single-seller ABS-backed commercial paper conduit
- Government and private-sector commercial mortgage- and other loan-backed securities;
- The first: rated private MBS, Z class, PAC securities, shelf registrations for MBS and ABS and book-entry MBS;
- ABS-supported asset-backed commercial paper; and
- Revolving loan and mortgage pool securitizations.

His practice includes counseling US and multinational corporations, international financial organizations, domestic and foreign regulatory agencies and self-regulatory organizations on a variety of financial services matters. Mr Feldkamp has consulted on projects to enhance legal, regulatory and accounting rules to facilitate securitization in countries throughout the world.

Other areas of Mr Feldkamp's practice include representation of financial service companies on all aspects of their business, including corporate law, mergers and acquisitions, regulatory and operational matters, workouts, reorganizations and bankruptcy matters. In addition, he has been involved in numerous bank, thrift and finance company restructurings. He has advised on highly leveraged bond transactions, including procedures to assure legal compliance and as counsel in proceedings to unwind and reorganize highly leveraged issuers.

Mr Feldkamp authored the US article for the Securitization Yearbook 1999, a supplement to the International Financial Law Review (September 1999), the overview articles for the 2000, 2001, and 2002 yearbooks and the US article for the 2003 yearbook. He also authored "Who Let the Bears Kill Goldilocks?" *Futures & Derivatives Law Report*, Volume 23, No. 5 (July-August 2003) and co-authored "Rethinking the Role of Recourse in the Sale of Financial Assets", The Business Lawyer, Vol. 52, No. 1, November 1996. He is a graduate of The University of Michigan (AB, Economics, with distinction, 1968; JD, magna cum laude, Order of the Coif, 1971) and was a student fellow on the Research Seminar in Quantitative Economics. He was the legal profession representative to the FASB 140 Audit Issues Task Force of the Auditing Standards Board, American Institute of Certified Public Accountants.

record recovery in spread since October 2002, the US finally began to see real job growth in March and April of 2004. Fear of a return to a credit monopoly, however, delays growth well beyond the time of a decision to end it.

The profits of monetary institutions from higher market risk spreads do not create benefits because a spike in the credit cost of growth starves production and competition in the real economy. From 1998 to 2003, any growth firm that leveraged to grow at a low point on the chart faced extinction if it had to refinance its leverage near a high point. Moreover, each spike choked off growth of demand, making plans for expansion obsolete. Lenders didn't benefit; they merely created short-term profit for certain silos within the banks that reduced the collection value of the banks' assets. Borrowers faced credit famines that created no net gain for lenders.

How stupid can people be? "Fool me once [as occurred in 1990], shame on you; fool me twice, shame on me." Fool me nine times (since 1998) and shame on everyone. The creation of, and subsequent failure to fix, this gaping defect in the US banking system is an international embarrassment. Events are once again confirming the need to resolve this.

The 19th turn – is it a hole?

The final three predictable turns on price trend 3 coincide with events that would either end or support the Bank Conduit monopoly in US debt markets.

Turning point 17 occurred when it appeared the FASB and SEC would accept the expected-loss tranche loophole to avoid consolidation under FASB's revised FIN 46. That restored the power of Bank Conduits to raise credit costs. Turning point 18 coincides with widespread disclosure that Citigroup covered the expected loss to investors in its Eureka conduit with respect to Parmalat, confirming Citigroup's obligation to support those investors. That restored hope for competition to lower the power of Bank Conduits.

Turning point 19 coincides with publication of the first analyses of new asset-backed securities proposals (approved by the SEC on April 28). By failing to address 1940 Act rules of 1998 which must be fixed to open greater access to commercial paper investors, the SEC is repeating a mistake it made during the 1980s. If the SEC fails to heed the 1940 Act lessons of 1990, 1992, 1994, 1998, 2000 and 2002, US corporate debt markets are likely to fall into yet another hole.

After turning point 19, spreads for corporate borrowers rose as losses incurred to unwind carry trades were shifted from investors to the productive side of the economy, despite the generation of enormous short-term cash positions at 0% funding costs. When carry trades were unwound in 1994, there was no spike in corporate debt markets. Competition kept funds flowing to businesses at reasonable prices.

In less than two weeks, this latest spike created a $600 billion drag on US equity values. Continuation or reversal of that trend could determine the US presidential election of 2004.

How long has it taken to resolve this in other markets?

Ending the effect of a credit monopoly is very hard. Even 160 years after the British bank monopoly formally ended, customers in England and Wales are, it

appears, still suffering. In 2000, Don Cruickshank wrote a report calling for an end to centuries of monopoly banking practices in England. In 2002, the UK Competition Commission found England and Wales, but not Scotland and Northern Ireland, suffered substantial damages by the British banking monopoly/oligopoly.

The solution proposed in the UK is a call for mandating a spread to compensate small businesses for damages by giving them interest on checking accounts. That is an approach the US abandoned as useless more than 30 years ago.

In his March 20 2000 transmittal letter to the UK Chancellor of the Exchequer, Cruickshank recognized the difficulty of bringing true competition to markets affected by long-standing monopolies:

"A culture change is required, even within the Treasury itself. The recommendations in the report cannot deliver that. It needs a political determination that competition should thrive in this vital sector of the economy."

The continuing problems of UK (and European) bank monopolies, whether exercising power or crumbling, can still be observed in the financial press. *The Wall Street Journal*'s March 30 2004 "Heard on the Street" column reports that European banks are hoarding cash in unprecedented amounts. That is consistent with the market power of a monopoly, but it is also consistent with a crumbling of monopolists.

Without competition, banks can hoard cash by denying loans except at rates that reflect their pricing power. With competition, US experience (1993 to 1998) shows that banks are forced to lend or face ever-mounting cash reserves as customers repay loans. Eventually they are forced to match competitors or repay their deposits and dissolve.

With competition, banks are forced to lend at what Smith would call the natural price of money or go out of business as their loans and deposits are repaid. Creating true credit competition in Europe by allowing financial assets to be sold freely would greatly benefit every European by increasing the amount, and reducing the net cost, of credit. Unfortunately, European legal, tax and accounting systems have not been designed to support a full and free exchange of financial assets. It took the US nearly 60 years to make revisions that support its markets.

The 20th century US story of bank monopoly pricing actually began with a legally mandated banking monopoly, created by Acts of Congress in the 1930s. By the 1960s, that fostered the famous Rule of 3-6-3. Bankers took deposits at 3%, made loans at 6%, and were on the first tee by 3pm.

The US overcame those rules in consumer credit by the late 1980s. That solution is a model for the whole world to follow, and provides the foundation on which, finally, the US is now able to build business lending competition that eliminates the devastating consequences of monopoly.

Just the hope of restoring natural credit pricing to corporate debt markets, combined with accommodative monetary and tax policies, brought a historic recovery from the market despair of October 2002. Whether US reform will finally achieve rules that foster true competition in corporate debt markets, however, will depend on the resolve of FASB and the SEC, heartily endorsed by Congress, to finish the job despite concerted lobbying efforts from a few advantaged groups within certain banks (and some regulators who have mistakenly accepted false arguments made to support the loopholes and barriers that permit monopoly power to continue).

The gimmicks that allow this monopoly of corporate credit may represent the single most damaging economic mistake that the US has brought upon itself since the Great Depression

Aiming for price trend 2

Productive businesses are, in many respects, mere conduits. They absorb inputs, produce outputs and compensate creditors, employees and shareholders. When credit costs rise, payment for some other output must necessarily fall. When credit costs rise above what the business can sustain, the business dies. When many businesses face credit starvation, the result is economic famine, a recession or worse. Financial businesses can only thrive if their customers can pay. So credit cost starvation helps nobody.

The world can end credit famines, and assure financial market stability. The US experience of 1992 to 1998 shows the possibilities that arise by achieving that goal.

The key is competition in credit. Nobel Laureate Amartya Sen has shown that human famine does not exist in democracies that support freedom of expression. Voters reject elected officials that support policies that are so callous as to create food famine. Experience in US financial markets over the past 16 years has similarly shown that credit famines can be eliminated by open and fair competition in credit, supported by transparent presentation of the financial condition of market participants. That allows Adam Smith's invisible hand to foster policies that maximize economic potential and minimize instability.

Federal Reserve Board Chairman Alan Greenspan recently told the New York Economic Club that market problems were not with institutions, but with silos within those institutions that use procedures to gain short-term benefit for their silo, to the detriment of the institutions they serve. With true and lasting reform, profits for those silos will come from creating riskless arbitrages that create stability and growth, not from market making powers to raise prices and destroy investment value.

In true and lasting competition, bad debt losses fall, efficiency rises, customers' prospects improve, lending rises, and financial institutions prosper along with their customers. Diversification of credit decisions may also be the world's best defence against financial terrorism.

It is only price trend 2 that is desirable. We know how to achieve it. The FASB must finish the job it began in October 2002 and the SEC must fix the 1998 rules that created today's credit monopoly/monopsony.

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Ending monopoly

by Frederick Feldkamp, Foley & Lardner LLP

The April 26, 2004, issue of *Time* lists 100 "of the world's most influential people." The list includes one central banker, and it's not Alan Greenspan. *Time* selected "Japan's Greenspan," Toshihiko Fukui, for this honour.

Mr Fukui "just completed his first year as head of the Bank of Japan. 'Out of 100 points, I give his performance a 99,' says Jesper Koll, chief Japan analyst at Merrill Lynch in Tokyo. Some have gone so far as to call Fukui, 68, the best central banker in the world." *Time*, April 26, 2004, page 61.

Why?

Again, *Time* quotes Mr Koll: "For the first time in a long time, Japan has something approaching integrated monetary, fiscal, banking and competitiveness policies."

It is the last of these policies, "competitiveness," that is the focus of this article. Mr Fukui has helped generate a miraculous recovery in Japan by introducing actual and perceived competition into Japan's corporate debt markets. He is having the Bank of Japan buy securities backed by corporate loans. By this lever, the Bank of Japan is prying open (and liquefying) Japan's stagnant banks. In the process, Mr Fukui is saving Japan's banks and helping businesses to recover from a monopolistic financial "death spiral" that plagued Japan for more than a decade.

Competitiveness and finance

Understanding monopoly is easy; ending monopoly is the hard part.

A century ago, Lizzie Magie invented the real estate trading game which became Monopoly. She was a Quaker trying to teach local landlords the problems of concentrated market power and ever-increasing land rents.

As fewer landlords controlled more land, rents rose and tenants were forced to spend more for rent than they were able to earn. As a result, tenants on which landlords depended for income faced bankruptcy.

The lesson of Monopoly comes at game's end. One player owns everything and everyone else is broke. Unfortunately, that means all users of the winner's property are without funds to pay rent.

Ms Magie's moral is that the "winner" is just as broke as the losers.

In the board game, players start over, getting a new allocation of cash and a minimum income, paid from a central bank. The financial monopoly keeps productive players liquid.

The real world of banking is much more complex. When private sector banks are stuck with uncollectible loans, experience in Japan and elsewhere is that they sometimes cannot make new loans because they cannot liquefy their old loans except at a loss. When that happens, the central bank's liquidity either supports existing bad loans or is recycled back to the government. The financial monopoly needs a new way to fund a new game. By agreeing to buy securities backed by loans, Mr Fukui created a new way to open that market.

Japan's problem is not new. It arises because sovereigns control money and private banks are their instruments for monetary distribution. Sovereign monopoly of finance has often led to instability of financial markets. When the sovereign errs, the economy suffers.

The revolution which created the US was, at least in part, a revolt against the adverse effects of a British bank monopoly. In 1695, the UK Parliament granted monopoly power over exchange to the Bank of England.

Adam Smith, "the father of modern economics," described the harm which a monopoly of finance generates. He wrote *The Wealth of Nations* while the Bank of England controlled a UK monopoly over finance. He compared the effects of monopoly and competition on prices as follows:

"The price of monopoly is upon every occasion the highest which can be got. The natural price, or the price of free competition, on the contrary, is the lowest which can be taken,

not upon every occasion indeed, but for any considerable time together. The one is upon every occasion the highest which can be squeezed out of the buyers, or which, it is supposed, they will consent to give: The other is the lowest which the sellers can commonly afford to take, and at the same time continue their business." Adam Smith, *The Wealth of Nations*, page 87.

As the UK speculated in such follies as the "South Sea Bubble," the Bank of England's monopoly allowed it to shift bank losses to good borrowers by pushing up the price of credit. That pushed more loans into bankruptcy, creating the same death spiral we saw in Japan before Gov. Fukui stepped in. By the late 18th Century, British taxation of exchange in the colonies (to cover losses and wars) helped to convince merchants of Boston to throw tea in Boston Harbor and join others to foment a revolt that created the US.

The UK lost its American colonies long before the Bank of England lost its monopoly (1844). Unwinding the effects of a monopoly over exchange, whether created by law or "regulatory contract," has proven extremely difficult in the UK and in the US. More than 150 years passed since the Bank of England lost its monopoly on issuance of scrip when a 2000 report on the damage of monopolies in British banking lamented:

"A culture change is required, even within the Treasury itself. The recommendations in the report cannot deliver that. It needs a political determination that competition should thrive in this vital sector of the economy." From the Forward of Competition in UK Banking: A Report to the Chancellor of the Exchequer, Don Cruickshank, March 20, 2000.

In the span of a year, Governor Fukui and the Bank of Japan apparently achieved a "culture change" supporting "competitiveness" which has eluded the UK (and much of Europe) for centuries. He created an alternate source of credit for business. As he assumed office, Governor Fukui declared that the Bank of Japan would buy securities of bank- and non-bank-affiliated asset-backed securities issuers ("ABS issuers"), and he has followed through on that declaration.

If non-bank ABS issuers are well-structured, managed with diversity of assets and funding sources and allowed to compete with banks, it takes only a little outside funding to break a logjam at regulated banks. That's what we've seen in Japan. Once there is competition, banks can't charge good borrowers for the banks' past mistakes. New funding sources allow borrowers to leverage and grow. In turn, they are able to repay loans that banks considered uncollectible.

But why is this latest victory over the effects of financial monopoly uniquely Japanese?

In the UK and Europe, efficient ABS issuers are commonly limited (by law) to nominees of sponsoring banks. Governor Fukui's innovation cannot break monopolies by giving more money to the monopolists.

In the US, anyone "can" be an ABS issuer, but accounting gimmicks and restraints, combined with arcane rules of the US Securities and Exchange Commission (SEC) and bank regulators, effectively ceded the short-term ABS issuer market to a few banks in 1989 and again in 1998. Chairman Greenspan announced that the Federal Reserve System would buy bundled corporate debt years ago. As a result of those rules, gimmicks and restraints, however, the US became stuck in the same "muddle" as the UK and Europe.

Scandals of Enron, Parmalat and others have revealed the gimmicks by which ABS issuers of a few banks have monopolised short-term corporate credit in the US to everyone's detriment (including the monopolists). Most of those gimmicks originated as "regulatory accounting policies" which the US Congress has sought to abolish since 1989.

We know how to end credit monopoly (with profits for all) by embracing "competitiveness" policies similar to those espoused by Governor Fukui. Steps in the direction of competitiveness started in October 2002 and US investors quickly saw the benefits. If the US finishes the job, the whole world will benefit, but there is lingering doubt that the US can overcome its past errors.

Cornering ABS issuer CP and its consequences

How did the US fall behind Japan on these matters?

As a result of sound asset securitisation processes, since the mid-1980s ABS issuer competition has dominated the consumer finance markets in the US. Since then, the consumer economy has experienced a level of stability which had not been seen before. For most of the past 16 years, however, stability has continued to elude US corporate credit markets.

Access to commercial paper (CP) markets (primarily money market funds) is essential for ABS issuers to competitively fund corporate debt. Without access to CP, ABS issuers cannot easily fund business loans that rise and fall in balance, cannot match the funding diversity of portfolio lenders and are not efficient vehicles for supporting the Fed's monetary policy.

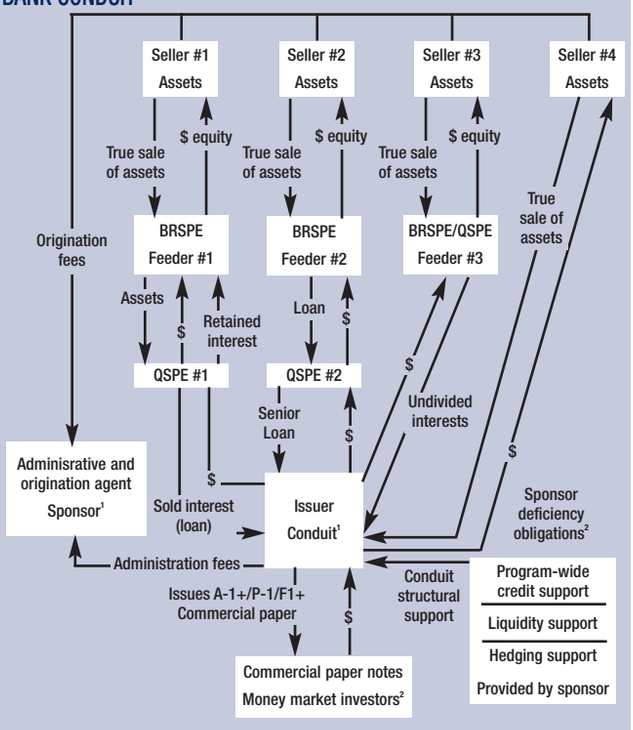
The US ABS issuer CP market has become dominated by a few large banks that were given regulatory authority to hide corporate loans supported by CP in the 1980s, despite the banks' full support (with FDIC-insured deposits as their fallback for liquidity) of the debt of those issuers. If banks are forced to use structures that competitively spread the government's liquidity support and the SEC reopens CP markets to non-bank ABS issuers, Governor Fukui's miracle will work in the US.

To understand how banks have gained dominance of US ABS issuer CP is to understand the reasons for instability in US corporate debt markets since 1988.

The next page has three charts. The first two describe the main types of ABS issuers used to issue CP today. The first is the "bank conduit" structure supported by regulators in the 1980s. The second became available by SEC rules enacted at the end of 1992 (the "QSPE conduit"). The only real difference between them is the bearer of "deficiency obligations." For bank conduits (and Enron's variations of the structure), it's the "sponsor." For QSPE conduits, it must be "unrelated parties."

The third chart tracks changes in US credit markets (commercial and consumer), and US equity markets after the "crash" of 1987. Corporate credit crises associated with the

BANK CONDUIT

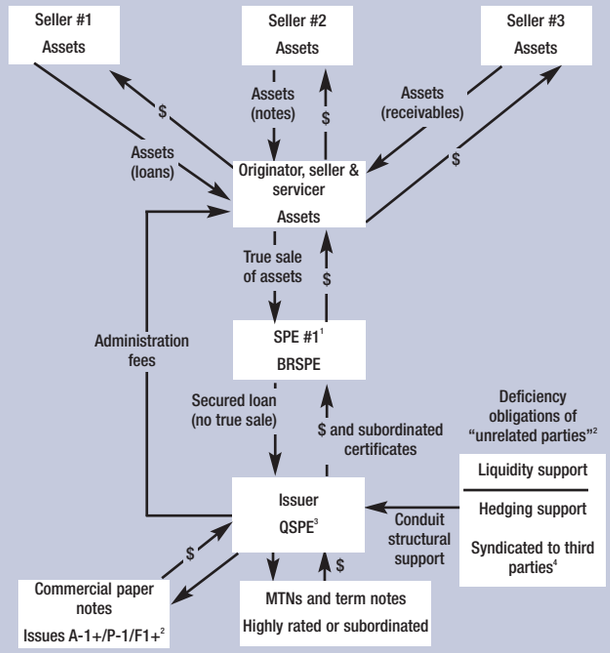


[1] Banking law precludes sale treatment when deficiency obligations reside with a bank. Therefore neither SFAS 140 nor QSPE status is available.

[2] In aggregate, structural support covers all expected deficiencies of the conduit and provides 100% hold harmless protection to commercial paper holders.

Source: Foley & Lardner LLP

QSPE CONDUIT



[1] There may be more than 1 BRSPE between the seller and the QSPE to address specific issues. Non-consolidation of the issuer is necessary for non-bank sellers (to avoid "scrambled eggs") that create bases for consolidation in bankruptcy.

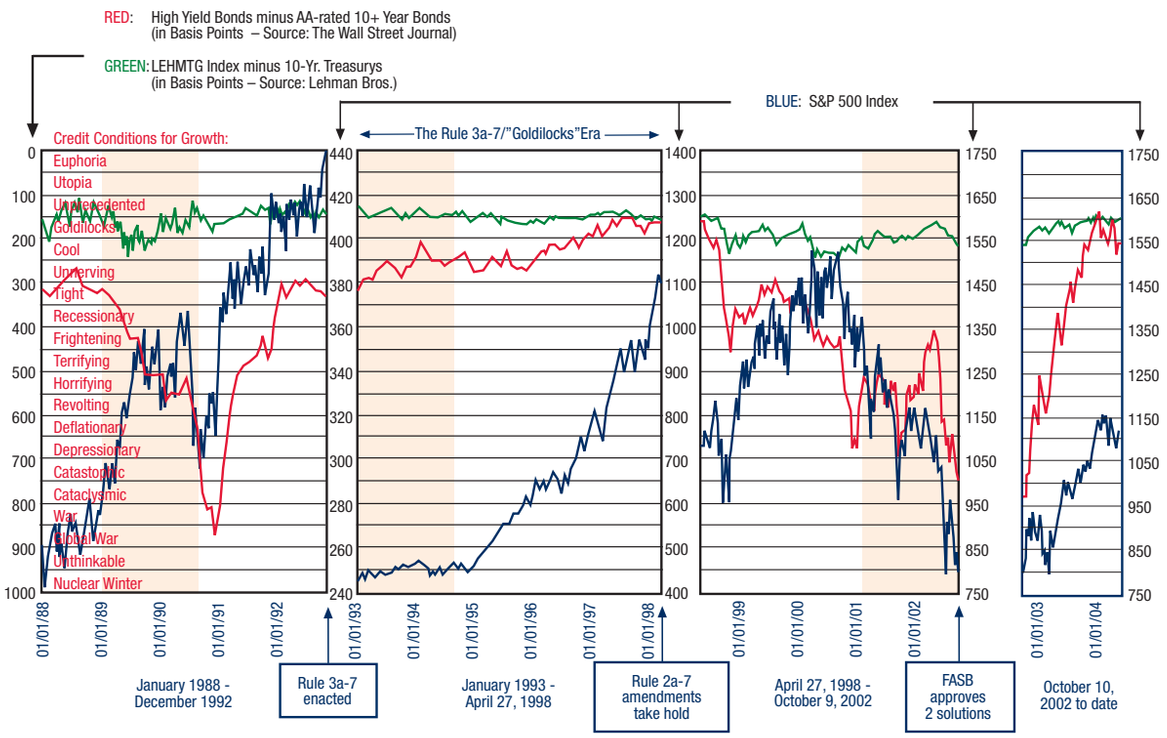
[2] In aggregate, structural support covers all expected deficiencies of the conduit and provides 100% hold harmless protection to all commercial paper holders.

[3] The absence of deficiency obligations of parties related to the conduit permits it to be a QSPE.

[4] To the extent that these are not covered by credit support inherent in, or embedded in, assets isolated at the BRSPE (SPE #1).

Source: Foley & Lardner LLP

CHANGING MARKETS AND CREDIT CONDITIONS FOR GROWTH FIRMS



Source: Foley & Lardner LLP

market power of bank conduits can be seen in the performance of US corporate debt markets in 1990, 1998, 2000 and 2002.

The red line on the third chart tracks the "net" price of corporate credit (risk spreads) in US markets since 1988 (before widespread use of bank conduits). Conditions in that market are associated with a series of terms at the left side of the chart. They describe the impact of spreads on credit market perceptions of corporate executives. The price of credit is inverted on this chart, so debtors' pain rises as the red line falls (for a detailed analysis of each twist and turn of this chart between 1988 and 2003, see "*Who Let the Bears Kill Goldilocks?*" by Frederick L. Feldkamp, Futures & Derivatives Law Report, July/August 2003, Vol. 23, No. 5). Inversion demonstrates the direct and logical correlation between changes in spread and the direction of equity market prices.

The chart also compares corporate credit conditions to consumer credit, using the "net" price of fixed-rate residential mortgage loans (the green line) in each of four periods. The chart shows equity values based on the S&P 500 Index (the blue line). Those three markets total US$30trn to US$40trn, dwarfing the US Treasuries market.

As the net price of corporate debt (spread) rises, the chart shows that the value of stocks almost always falls. If that doesn't happen (for example, 1999 and early 2000), investors' "exuberance" certainly seems "irrational."

Finally, the chart plots government involvement, using yellow "transition periods" after a new US president is elected. The chart reflects US financial market conditions during the period of Fed Chairman Alan Greenspan's stewardship following the stock market crash of 1987.

The bank conduits approved by regulators in the 1980s were first tested in 1990, when Iraq invaded Kuwait. They failed. In 1992, enactment of Rule 3a-7 under the Investment Company Act of 1940 (the '40 Act) allowed QSPE conduits to develop and compete with bank conduits. The "Goldilocks Era" followed as competition contained spreads until debt incurred to survive the spike of 1990 could be equitised.

Can the US repeat the "Goldilocks Era" during the next cycle of rising interest rates?

In 1998, the third chart says "Rule 2a-7 ['40 Act] amendments take hold". As a result, competition from QSPE conduits became virtually impossible. Bank conduits, on the other hand, despite reliance on a single "sponsor" for all "deficiency obligations," were exempt from diversification requirements that preclude money market funds from investing more than 5% of their assets in a single obligor. A credit pricing crisis followed, the logical result of creating a monopoly/monopsony for a few sponsors of bank conduits.

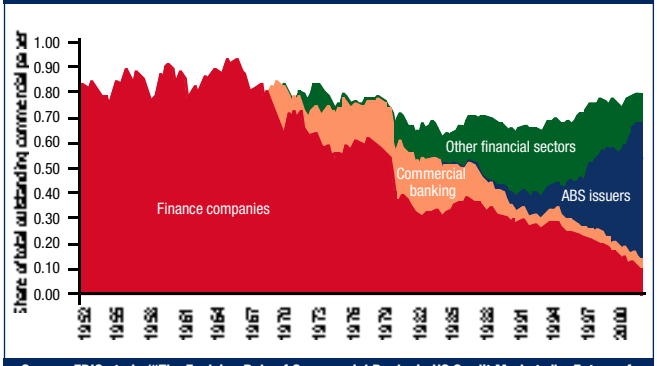
In 2000 and in 2002, the Financial Accounting Standards Board (FASB) tried to restrain bank conduits (by requiring consolidated disclosure under GAAP). Without QSPE conduits to fill in the void, however, pricing crises occurred as sponsors of bank conduits restrained credit.

In October 2002, the FASB ruled that QSPE conduits (where "deficiency obligations" are diversified) can compete and that bank conduits (without diversified "deficiency obligations") must be consolidated. A miraculous recovery followed.

As regulators provided capital relief to allow consolidation of bank conduits and investors pursued yield, US corporate credit markets recovered dramatically. Bank conduit dominance, however, still overhangs the markets. Without vigorous defence of financial transparency and open competition in debt markets by the SEC and FASB, US bank regulators still appear ready to accept controls and gimmicks.

The following chart shows how effectively bank conduits have "swallowed" the CP market. Today, virtually all "ABS issuers" of CP are bank conduits. Like the victor in Monopoly, in 1990 and between 1998 and 2002, bank conduits were able to raise prices of credit and still drive competitors out of the market. By October 2002, the "Changing Markets . . ." chart shows that the US was approaching the bankrupted end of Monopoly. Sponsors of bank conduits faced record levels of corporate bankruptcies. The bank conduit monopoly was harming banks and borrowers alike.

FIGURE 9. COMMERCIAL PAPER OWED BY FINANCIAL SECTORS



Source: FDIC study ("The Evolving Role of Commercial Banks in US Credit Markets," a Future of Banking Study by Katherine Samolyk, March 25, 2004).

Why was the bank conduit created?

Bank conduits arose as Congress determined to shut insolvent banks and thrifts in the 1980s. The last time such a massive bank restructuring was undertaken, the world endured the Great Depression. Clearly, caution was in order. How could so many credit suppliers be closed without choking off credit?

In 1989, SEC restraints precluded effective CP arbitrages by non-bank ABS issuers for many types of non-mortgage corporate debt. Facing a liquidity crisis, bank regulators (led by the US Federal Reserve Board), the SEC and the FASB endorsed a loophole that was supposed to allow a few banks to hold very high grade corporate lending portfolios off-balance sheet. That loophole allowed the banks to hide changes in leverage and exclude assets from bank capital calculations.

The loophole was a reasonable temporary solution until the SEC could fix its rules and open competition to diversified risk "QSPE conduits" (1992). Bank conduits should have been restructured as QSPE conduits during the "Goldilocks Era" of the 1990s. By the late 1990s, the loophole had expanded to

Enron and others, and was no longer limited to "high grade corporate lending." For example, Parmalat loans were recently found in a Citigroup conduit.

What gives bank conduits power to dominate CP markets?

The regulatory contract creating bank conduits gave sponsors the choice of selling their US-backed liquidity to borrowers and independent credit providers or to bank conduits that returned all their profits to the sponsor (with no reserve requirements, deposit restraints or deposit insurance fees). Though all losses of bank conduits are absorbed by the sponsor (through mandatory deficiency obligations), normal regulatory protections did not apply.

Any fool can guess where the sponsors allocated their liquidity.

Bank conduits pose a "heads, I win; tails, the taxpayers lose" moral hazard risk that is economically identical to the one which led to the S&L crisis and Congress' "Never again" legislative solution of 1989 (FIRREA). Being able to choose to "sell" liquidity to conduits of other managers, or to retain all the benefits of the US government's financial monopoly for themselves, what banker will "choose" to foster competition?

As with other regulatory accounting gimmicks and "tying" concerns, the real risks of bank conduits are moral hazard and the harm to bank sponsors and bank customers of monopoly pricing behavior (as we saw in 1990, 1998, 2000 and 2002). As long as bank conduits really do invest in competitively-priced, rock-solid, well-diversified, fully-secured loans, "0%" regulatory capital is probably reasonable.

How can the US unwind bank conduits without a crisis?

Competitiveness in finance is the answer. The third chart on page 18 shows the remarkable recovery in corporate credit pricing since the FASB took steps to support competition in October 2002. The benefits of that trend must be preserved so that borrowers can equitise their debts before rising interest rates foreclose those options.

When QSPE conduits (and other structures with diversified deficiency obligations) supplant bank conduits as permissible "off-balance sheet" ABS issuers, the US will enjoy lasting "competitiveness" and stability in corporate credit (See "*Removing the 'D' from off-balance sheet—FIN 46 and Statement 140*" by Frederick L. Feldkamp, Structured Finance Yearbook 2003 (supplement to International Financial Law Review), October 2003). As long as a single bank can sponsor bank conduits, managing their assets and liabilities and providing all "deficiency obligations" and report no liabilities, the US remains at risk of being thrown into periodic "death spirals" of corporate credit pricing.

Assuring stablility

Instability associated with excess reliance on bank conduits is most clear during the period after QSPE conduits were constrained in 1998, until 2002. Former Fed governor Wayne Angell recently labelled this period "The Rubin Recession." (The Wall Street Journal, March 25, 2004, page A16). Mr Angell attributes adverse trends of 1998-2002 to a shrinkage of US government debt that was not matched by a growth of other debt.

Mr Angell's argument regarding credit is persuasive. But it's hard to blame Mr Rubin for this. Before the crisis of 1998, Mr Greenspan surely expected continued growth of corporate debt structures. When asked how he'd replace Treasury securities for conducting monetary policy as federal borrowings shrank, Chairman Greenspan said the Fed would buy bundled corporate debt, that is, obligations of ABS issuers.

Since the bulk of Fed monetary activity relies on short-term securities, CP of ABS issuers was the obvious instrument on which the Fed would focus. By the SEC's 1998 rules, however, virtually all the ABS issuer CP available was from bank conduits. When sponsoring banks were reluctant to lend, bank conduits raised rates and restricted lending. That meant the Fed's monetary accommodation sought to push liquidity through "pumps" that had been shut off by their primary beneficiaries.

As a result, from 1998 to 2002, the US periodically caught Japan's monetary "flu" because it could not adequately liquefy corporate markets. The Fed needed a large supply of non-bank ABS issuer CP to achieve its intended goal. The SEC's 1998 rules prevented creation of the necessary supply.

Creating a Culture Change

Under the 2002 Sarbanes-Oxley Act, it is up to the FASB and the SEC to open corporate credit markets to competition and to close the loopholes bank conduits have used to gain market power. Chairman Greenspan openly complained about the risks of market making power being held by a handful of banks in 2003. Regulators at all levels must voice ongoing commitments to a true competitiveness policy and openly support true reform (see, "Favorites," CFO, April 2004, page 47).

If we are to succeed, regulators should actively support the creation of off-balance sheet QSPE conduits and demand on-balance sheet treatment for bank conduits (and their eventual elimination or conversion to entities with diversified management and deficiency obligations). QSPE conduits diversify obligations and should be reported separately. Bank conduits are mere nominees that centralise obligations in a single sponsor and should be reported by the deficiency obligor that manages each bank conduit.

Regulators must also preclude restrictive practices by institutions under their jurisdiction that now allow them to tie services and unfairly favour their own ABS issuers or other affiliates when allocating FDIC- and SIPC-guaranteed liquidity. While a transition is appropriate, QSPE conduits should replace bank conduits.

"Figure 9" may demonstrate that we are nearing the end of Monopoly. Will we go broke or smoothly re-liquefy markets and start over? Economic success during the upcoming period of rising rates will, at least in part, hinge on whether the US creates a culture of "competitiveness" in corporate debt markets as successfully as appears to be occurring in Japan. To

avoid the "crash" which comes at the end of Monopoly, we need new competition to assure that banks continue to fund business fairly, to everyone's benefit, so that equity markets can recover and replace debt with new equity.

The heads of Citigroup and Bank One have stated their organisations' commitments to policies that support competitiveness. Citigroup's recent experience with Parmalat loans establishes the need to recognise bank conduits as mere nominees of their sponsors. Organisations that have pushed competitiveness are handsomely profiting as business confidence (and growth) is returning. It is up to banks and bank regulators to overcome any "silos" of resistance to competition which remain within the banks.

Corporate Debt Markets

Financial competition relies on greed to propel it. An SEC commissioner recently said "greed is bad." That's wrong and right. Some greed is bad. However, greed that is harnessed to a virtuous purpose of financial market stability, and is contained by effective competition, is good. Stability propelled by greed gave us the "Goldilocks Era" of 1993 to 1998.

Market differences between an "asset securitisation" which legitimately supports stand-alone liabilities and a "liability securitisation" which falsely hides corporate leverage are immense. The former stabilises markets with competition while the latter destabilises them, fostering Enrons, Parmalats and all sorts of scandals.

Experience, good and bad, has taught that investors' interests are the paramount consideration for successful market structuring efforts. Those interests are best served by eliminating all vestiges of regulatory accounting and disclosing, as a liability of a "sponsor," all obligations of any special purpose entity that is both managed and guaranteed by a future payment obligation of the sponsor. In addition, where financial assets are not isolated beyond the recovery powers of a "seller" or its receiver, or the "seller's" own liability stands behind obligations owed to a "buyer," a "loan" is created, not a "sale."

Implementing these reforms eliminates loopholes which have been used to hide debts (such as bank conduits and participations) that are, in fact, liabilities of their related sponsors. Once on-balance sheet, bank regulators can set capital requirements appropriate to measure real risk. In proper cases, the capital requirement should be very low.

Where assets are truly isolated by a transfer, and a sponsor merely manages the assets of a special purpose entity, the sponsor has created a stand-alone riskless-arbitrage entity. The sponsor does not "own" the entity's assets or "owe" its liabilities. The fact that the sponsor holds isolated and truly subordinate minority interests in the arbitrage entity does not matter, at law or otherwise, as long as there is no deficiency liability and risk of loss (on the retained interest) is measured correctly.

Investors often require that servicers hold subordinate interests in isolated assets to protect against moral hazard risk. Unfortunately, the FASB chose to preclude most such interests (as late as December 2003). That must be fixed.

In the case of financial asset sales, as long as the seller cannot unilaterally repurchase assets or unilaterally force asset sales and the entity holding the assets has no corporate obligation owed to it by the seller or its affiliates, sale treatment is entirely appropriate. An ABS issuer (a QSPE conduit) must issue rolling CP to compete with portfolio lenders and on-balance-sheet bank conduits. That's an entirely good competitive result and an appropriate GAAP result as long as the servicer has no affirmative obligation to pay the QSPE's assets or liabilities.

Where there is a real asset transfer and no deficiency "obligation," properly isolated subordination represents a price adjustment, not a deterrence to sale treatment. It should be allowed (and praised). Non-transfers (normal loan participations), and guarantees of investors' holdings by sellers or servicers, are simply liabilities which must be disclosed as such.

These rules will close the regulatory accounting loopholes and open the barriers by which sponsors of bank conduits have been able to prevent competition. For balanced competitiveness, ABS issuers must be independent and have the ability to generate asset diversity by achieving adequate size and to generate liability diversity by rolling CP and creating term maturities in the same structure. FASB, SEC and bank regulatory rules must recognize this or the world economy will continue to suffer as US investors periodically flee corporate debt markets.

Denial of the ability of QSPE conduits to diversify assets and liabilities prevents competition for bank conduits from legitimate stand-alone entities. FASB can fix this by properly defining: "liabilities," "sales" versus "loans" and when support of a limited purpose entity creates consolidation in accordance with the above-noted principles.

Clearly, bank conduits with a single manager, liquidity provider and program-wide credit enhancer should be consolidated. The liabilities of such nominees are liabilities of the sponsor (note recent experience with Citigroup, Eureka and Parmalat). Stand-alone qualifying SPEs (with no deficiency claims against sellers or servicers), however, should be treated as separate entities, even though they "roll" maturities. The ability of banks to allocate liquidity to bank conduits over sound QSPE conduits of others creates perverse incentives to bury risk and must be eliminated.

Finally, to finish a true competitiveness policy, the SEC must fix the 1998 Rule 2a-7 amendments to add an exemption where special purpose entities have no majority backup liability obligor and truly diverse assets. Moreover, the notion that fully guaranteed nominee entities should have separate 5% limits for money market fund investment needs to be reversed over time. It's ridiculous that a single bank, sponsoring 19 bank conduits, can be the sole deficiency support for CP which would comprise all the assets of all the money market funds in the US. The SEC must fix that.

Mortgage Market Enhancements

Recommendations to allow competition for corporate debt will also resolve most of the mortgage market concerns that gave rise to the spread variance observed on the "Changing Markets . . ." chart between 1998 and 2002.

One US tax problem, however, must be resolved. The REMIC legislation of the 1980s no longer needs to be "exclusive." That exclusivity, combined with loopholes in GAAP, enhances the monopoly of government-sponsored enterprises (GSEs) in mortgage markets.

The US Internal Revenue Service adopted "check-the-box" rules after REMIC. Those rules demonstrate that consistent tax treatment is the key to avoiding abuse, not exclusive tax treatment. Moreover, "taxable mortgage pool" rules (which predate REMIC) should be revised to accommodate non-abusive "check-the-box" structures.

Finally, armed with the tools needed for effective competition with mortgage GSEs, remedies to unwind the implicit support which the US government provides to GSEs will become obvious. Done properly (with mortgage-market competition maintained), fully and fairly privatising US mortgage markets will benefit consumers and not harm home values.

Conclusion

Stability in US corporate debt markets will be restored by a uniform policy favoring competition. Among other things, that requires the rise of QSPE conduits and fall of bank conduits.

Bank conduits were a necessary evil for about three years (1989-1992). By 1998 they became vehicles whereby a single US bank could monopolise (and monopsonise) CP markets (money market funds) by diverting its FDIC-insured liquidity backup to asset pools managed and guaranteed by the bank, but not subject to normal regulation or disclosure.

By 2002, the value of these FDIC-insured liquidity benefits, which are a primary instrument of sovereign monetary policy, was being diverted from bank customers and shareholders to the benefit of groups within banks that ran bank conduits. As credit prices rose, managers got short-term benefits, which were more than offset by declines in the banks' asset values. Between 1998 and 2002, US banks and their customers suffered enormous portfolio losses (roughly US$3.4trn), while managers earned extraordinary compensation.

At the brink of disaster, on October 9, 2002, the FASB effectively declared: "Let the recovery begin." They began a road to competitiveness by voting to mandate consolidation of bank conduits and reject bank-sponsored efforts to preclude development of QSPE conduits. It is time to finish the job the FASB began in 2002. Recent efforts of bank regulators to sidetrack reform must be rebuffed.

Since October 9, 2002, conduit-sponsoring banks and their customers have enjoyed a miraculous recovery. The "Goldilocks Era" of US economics will return if and when true competition in corporate banking is restored.

US: STRUCTURED FINANCE

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Barriers, loopholes and the jobless recovery

Why do accounting and market structures matter? Capitalism will not work without markets by which investors can efficiently exercise their freedom to exchange assets. It is freedom to exchange assets (particularly financial assets) that gives capitalism its ability to adjust and allocate resources efficiently to create economic growth.

Recent experience, in Japan and the US, shows that we can pour all the liquidity we want into a system, but without reliable information and rules that are not rigged, investors will not invest enough money in those businesses that produce growth. Unreliable information, barriers and loopholes limit what investors want, so they preclude or defer economic recovery. As a result, everyone loses.

Investors' preferences are apparent in market behavior. Reliable and efficient markets support stable and sustained growth by a level, and low, relative cost of capital for growth companies. Rigged and opaque markets create vacillating, and far higher, relative capital costs.

When growth companies must pay more for capital than others, growth is not supported.

US markets became rigged as a result of a series of actions between 1989 and 1998. That is the root cause of today's worldwide economic malaise. In the US, a president that did not create the rules that rigged the market may lose his reelection bid if we fail to fix them in time. Despite the lowest interest rates in 40 years and record budget deficits, it seems possible that he will be blamed because the US recovery from the recession of 2001 has been anemic and jobless.

What's the solution?

First, markets won't function efficiently if investors are denied certainty regarding the information provided to them. That's what's at stake in debates on change of accounting rules. For an article that explains this, see "The FASB and the Capital Markets," John M (Neel) Foster, The FASB Report, June 2003 (available at www.fasb.org under Articles & Reports).

Second, markets are rigged when rules create needless: (1) barriers that limit access for parties and (2) loopholes that favour particular access. Both cause liquidity to flow to places where it is not needed. Both, moreover, are pursued by those who seek to profit by controlling and allocating liquidity. What they miss is that nobody wins at this type of Monopoly. The victor at Monopoly may hold all the property but all its potential customers are broke, leaving the winner as broke as the losers.

For a history of barriers and loopholes, and their consequences in US market behavior, see "Who Let the Bears Kill Goldilocks?", Futures & Derivatives Law Report, Volume 23, Number 5, July-August 2003. For some, the article may only cure insomnia. It shows that politicians, firms, and investors come and go. Sound markets support them, and rigged markets eventually expel them like the losers (and winners) in a global game of Monopoly.

Market rules that produce certainty, and allow neither barriers nor loopholes, are what we must create for worldwide economic recovery.

How can rulemakers distinguish barriers from loopholes?

One must study the consequences of each action. If eliminating a rule levels the playing field and grants no advantage to particular groups, the old rule was probably a barrier. Conversely, if a rule that creates an advantage is replaced by one that levels the playing field, the former rule was probably a loophole in need of closing. Finally, if certain players are advantaged by creating or eliminating a restraint, one is probably erecting a barrier or creating a loophole, respectively.

Accounting can be based on principles or rules. That does not matter. Accounting by either method leads to abuse and evasion if accounting standard-setters create barriers and loopholes to freedom of exchange.

Laws of market regulation and investor preference, as well as their economic consequences, have a clout that either humbles or destroys standard-setters, regulators, and elected officials. US leaders can repeat the mistakes of history or they can learn from them. For everyone's sake, I hope they choose the latter, and soon.

Frederick Feldkamp

FOLEY LARDNER
ATTORNEYS AT LAW

Who Let the Bears Kill Goldilocks?

Can we save U.S. corporate finance from its next crisis?

By: Frederick L. Feldkamp
July 14, 2003

WHO LET THE BEARS KILL GOLDILOCKS?

Can we save U.S. corporate finance from its next crisis?

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"[S]ecuritization has become the grease that keeps capital markets spinning."
Business Week, September 2, 2002, page 86.

INTRODUCTION

Securitization is the "art" of legally isolating "financial assets" and carving them into "components" that are sold as self-supporting.

Done properly, securitization may be the most important and beneficial financial innovation since the invention of double-entry accounting. When abused, the process can lead to scandals of the type seen in Enron's practices. Regrettably, we are now seeing how confusion over how to separate "good" and "bad" securitization can even create the ultimate risk of a financial collapse.

Done correctly, for example, securitization allows the U.S. Treasury to increase the efficiency of financing the national debt through the creation of "stripped" Treasurys. The process has been used to create efficient means to finance some of the largest companies in the world through restructurings that saved them from bankruptcy. Every homeowner and consumer enjoys almost immediate benefits from any easing of monetary policy through the "magic" of securitization.

Sound securitization must be allowed to thrive if we want an economy that is worthy of this great nation.

During the past five years we have watched in fear as markets have tumbled and the U.S. corporate economy has faltered. This article will show that much of the blame for this can be attributed to abusive securitization practices and well-meaning but misguided "reform" efforts. We are now at a point where failure to promptly end the abuses of securitization, combined with actions that have closed essential markets to issuers of sound securitization products, is rapidly pushing the nation down an awful path toward "deflation" (an economic "Black Hole" we have not seen since the 1930s but that Japan has now experienced for more than a decade).

Over the past 15 years, those that abuse securitization have, it seems, gained such market dominance that policymakers may fear "doing the right thing" will result in retaliation by those in control of this process. We must overcome that fear, and soon. The next set of institutions that could fall prey to the consequences of our failure to end abusive securitization practices and to support sound practices is the "money market fund" business (see "Falling U.S. Rates Increase Cost Pressure on Fund Firms," Jason Singer, *The Wall Street Journal*, June 30, 2003, page C-1).

During the past three years, we have seen that fears of retaliation are not without foundation. Once encountered and overcome, however, we have recently seen that our nation's major institutions will act correctly. In the end, their self-interest and that of their customers (and the nation) are aligned. The leaders of those institutions know that they can succeed only when their customers succeed (though they sometimes need external sources to remind them).

We can understand the motivations of capitalists and address them. What seems most fearful at the moment is confusion on the part of some advisors to business and regulators over what divides abusive and true securitizations. Confusion leads to policies that are built on folly. That isn't "evil," but that does not reduce its significance.

Trying to explain how the German people ended up following Adolf Hitler, Dietrich Bonhoeffer observed that: "Folly is a greater enemy of the good than evil." Evil could be explained and ended. Folly is much more difficult to overcome. It is simply illogical. Logic is demonstrable, but illogic is just inexplicable.

This article seeks to end some of the confusion by showing the fundamentals of securitization as it developed. This is a uniquely "U.S." invention, based on unique U.S. laws that arose in a unique response to a unique history. In the end, true securitization depends on:

(1) Legal isolation under U.S. bankruptcy and usury law precedents.

(2) The transferability and infinite divisibility of debt obligations and components of those obligations.

(3) The capacity of fiduciaries and servicers to serve the interests of all component holders without fear that rights of one will undermine rights of others.

(4) Recognition of "subordination" under U.S. bankruptcy law and the capacity to distinguish the limited rights of subordinate interests from the rights of obligors (debtors and guarantors) to redeem assets in equity.

(5) The ability to separate servicing from ownership and to create compensation and incentives that allow all parties to achieve their goals without fear of intervention.

(6) Computer capacity to keep all the interests of all component holders separated and accounted for on a continuous basis.

In the end, securitization can only "work" if it is done on an absolutely level competitive "playing field." All participants must be able to access all markets equally or the competitive advantages of disintermediation (the ultimate market benefit of securitization) will be lost, to everyone's detriment.

HISTORY: IT ALL BEGAN WITH MORTGAGES

Securitization of the U.S. residential mortgage market virtually assures that every homeowner is entitled to benefit from accommodative monetary policy. When necessary, moreover, securitization assures that the housing market will be restrained by a restrictive monetary policy. These trends helped create a "virtuous cycle" within mortgage markets that began to appear in the 1980s. This cycle, when applied broadly, allowed the Federal Reserve System to nimbly guide the U.S. economy throughout the "Goldilocks Era" (1992-1998).

It has been estimated that securitization has saved homeowners over $1 trillion in reduced mortgage interest charges since 1983, when the "Collateralized Mortgage Obligation" (the "CMO") was invented. These astounding benefits came at no loss to mortgage investors. How is that possible? Because securitization more efficiently matches the needs of both the borrowers and the investors in mortgages.

Between 1992 and 1998 the "secrets" of CMOs were increasingly applied to corporate and other obligations. As a result, during the "Goldilocks Economy" mortgage markets reached levels of efficiency not previously witnessed. Moreover, markets for corporate debt slowly began to track the virtuous cycle that existed in mortgage markets. As a result, modest interest rate moves by the Fed accelerated and decelerated the U.S. economy with relative ease.

As with all new creations, some abuse occurred and that must be stopped, but the undeniable benefits of securitization technology far outweigh the risks of abuse. In practice, those abuses became more prevalent after "Goldilocks" was run off by a "bear market" crisis in 1998. Did "the bear" of 1998 create such fear that it drove corporations and financial markets to resort to abuse as a means to cover advantages lost during and after the crisis of 1998?

Can we unwind abuse and regain market value through reform? This article says we can, if we do that reform correctly.

In 1998, corporate debt markets suddenly became disconnected with fundamental economic trends and consumer debt markets. A new "vicious cycle" began with a widening of corporate spreads that was a prelude to the "Hedge Fund Crisis" of 1998. The "bear" cycles which began in 1998 continue today. As a result, by 2000, rational responses of entrepreneurs and their bankers to the 1998 crisis probably contributed to creation of a "bubble" that the Fed seemed incapable of deflating before it burst.

Under "Goldilocks' invisible hand," markets never became "too cold" or "too hot." Since 1998, however, we have endured seven financial crises, only one of which (9/11/2001) was caused by anything other than our own homegrown folly. Recently, we have seen a rather miraculous recovery. The threat of an eighth crisis, however, a "liquidity trap" that threatens money market funds with "breaking the buck" (and the economy with deflation), now looms.

We have watched as 13 rate reductions have thus far failed to stimulate a corporate sector that has not grown, in real terms, since 1998. U.S. unemployment now stands at a 9-year high. Why have markets foundered despite "cheap money"? To explain this disconnect, and its catastrophic impact, one must look back at the history of financial markets. We could start at the development of currency (in China more than 24 centuries ago) but as the author of this piece, I choose to start with the Great Depression.

1928-1963
DEPRESSION AND RECOVERY

Between 1928 and 1932, U.S. financial markets imploded. John Maynard Keynes used the term "liquidity trap" to describe a deflationary spiral fed by increasing excess capacity, reluctance to spend (because assets would be cheaper at a later date) and budgetary policies that failed to stimulate demand. Milton Friedman described a pattern of monetary contraction whereby the Federal Reserve System failed to maintain an adequate level of monetary liquidity.

Ignoring theoretical economics, bankers faced an extraordinary dilemma at the end of the "Roaring Twenties." Many companies and consumers were unable to pay their debts. If the banks held or refinanced bad loans, they might not show losses. If they sold them, losses might undermine the confidence of depositors or even render the banks insolvent. Fear of a liquidity crisis, moreover, led bankers to build hidden reserves in case depositors demanded payment. They invested in government bonds rather than consumer credit and the working economy, thereby shifting liquidity threats to their customers by cutting off their loans.

The result was a "death spiral." Lizzie Magie might have "predicted" this problem years earlier, from a real estate investment perspective. She invented a game that became famous as "Monopoly." Few learn the game's ultimate lesson, however. Consider the dilemma of the game's "winner." Having driven all prospective customers bankrupt, there is no cash flow to support the value of the winner's assets.

The winner of Monopoly is just as bankrupt as the other players.

When banks stop lending within the economy or raise rates to collect losses on bad loans from their good borrowers, they are acting like monopolists. Monopoly in banking (either as a board game or as an economic practice) almost necessarily causes the value of the monopolist's assets to decline as the strategy destroys the bank's borrowers (who must pay for the bank's financial assets to have value). Bankers must make new good loans, moreover, either by borrowing or by selling old loans to keep the economy sound.

After the crash of 1929, lawyers also encountered a "Catch-22" when banker clients sought to liquidate good loans by selling them. Under common law precedents of that period, notably in New York, a business could require, as a matter of contract, that its banker obtain consent before selling its loan to a third party. During the 1920s, banks accepted such limits to assure the retention of good customers. In fact, however, these restraints ultimately prevented the bank from making new loans by cutting off the ability to sell existing loans.

While we now look back on such folly with humor, the practical consequence of requiring consent to transfer was a calamity. The only way a bank could sell loans "en masse" was through its own receivership. By wiping out shareholders, a receiver was empowered to overcome the debtors' defense to sale. Short of that, a bank that had trouble raising deposits was without means to create liquidity to fund new loans when the Fed adopted the restrictive policies that Milton Friedman criticized.

Faced with a non-functional system, in 1933 the U.S. chose to federalize most aspects of finance. We insured bank deposits, put "fences" around banks and other specialized lending institutions, and even regulated the maximum rate banks could pay on deposits (to prevent "speculation" with government-insured funds).

Thousands of banks were forced into receivership or conservatorship. It was well into the 1950s before some of those banks returned to private control. The process worked, but at a great cost in individual freedom, business creativity and the basic concepts of free capitalism.

In one case, a major bank that finally moved from government conservatorship back to private control in the mid-1950s found that its assets were comprised of 50% cash in vault, 40% government debt and only 10% loans. Sure, the bank had the liquidity to meet any crisis, but it was not serving that bank's business or consumer community. In fact, that pattern was a recipe by which the effects of our Great Depression lingered for decades.

Similar experience has now plagued Japan for the past 13 years. Some of the same issues now also affect Germany, the 19th Century home of our reserve system of private/public banking. As the Fed now tries to "push cash up" through banks (only to see lending sometimes fall in line with rates), we are becoming increasingly aware of the threat posed to our money market funds, and the financial system in general, by the prospects of real deflation.

How did we finally "unwind" the controls of the Great Depression and can we prevent deflation? Before the regulated financial markets created in the 1930s could be reformed, legal precedents which froze the system had to be undone. Scholars who experienced that era led the way. Most of the new rules were in place by the late 1960s. If we smartly apply those basic reforms, we can prevent deflation, but we must be careful not to disrupt the mechanisms that give us the liquidity we need.

We began to crawl out of controlled finance following general adoption of the Uniform Commercial Code (UCC). With guidance from an exceptionally skilled legal scholar, Grant Gilmore, Article 9 of the UCC declared debtor-controlled prohibitions on the transfer of debt obligations to be "ineffective." In commentary, draftsmen of that clause described those who supported a continuation of restraints on sale of financial assets as favoring a return to rules of law that had existed during our Colonial period (in effect, they suggested that objectors to change were being disloyal to the Revolution). In addition, the UCC established, for the first time, an ability of creditors and asset purchasers to uniformly assure priority claims to intangible financial assets.

The UCC (in combination with state-by-state real estate laws) created the means for building a new market in mortgage-backed securities. That market could finally be freed from impediments that destroyed

pre-Depression models. Under the UCC, if a custodian or trustee properly holds mortgage notes for the benefit of investors (secured parties or purchasers), it is only by conversion, or the confluence of various parties in a conspiratorial fraud, that investors can lose the rights which are evidenced by the mortgage note and the mortgage by which it is secured. This is the basic foundation upon which all securitizations, and the capacity to create component financial assets, have been constructed.

From the early 1960s to the late 1980s, these legal "ingredients" were combined to create an effective "potion" that magically preserved that most "American" of all financial inventions, the long-term, fixed-rate home loan. This allowed us to eliminate the home-loan-based savings and loan system that had been constructed so the government would be able to support such loans.

It is securitization practices built on these reforms which eventually gave us the liquidity necessary to permit effective deregulation of U.S. financial markets. The process to build those markets began in the 1960s and continues today.

1963-1988

THE INVENTION OF MORTGAGE-BACKED SECURITIES AND CMOs

Chart 1 compares the interest rate on long-term, fixed-rate residential mortgages to the yield on 10-year Treasurys during the formative period for mortgage-backed securities. For ease of comparison to later charts, the vertical scale runs from 0 to 1000 basis points, though mortgages have never sold at spreads wider than 300 basis points over 10-year Treasurys since the early 1960s.

Within this range of pricing spreads, this chart is reminiscent of an electrocardiogram. It reveals, however, several significant developments. In the early 1970s, the government began to market pass-through certificates backed by mortgages. Spreads fell as this innovation was absorbed, but soon moved back up as their benefits were assimilated by regulated institutions and government agencies. In the late 1970s, private pass-throughs were created, along with "builder bonds" (aided by tax incentives). Again, spreads fell then went back up as a regulated market "swallowed" them.

In 1983, the CMO emerged and spreads fell nearly 150 basis points. As qualifying collateral was soaked up, however, spreads again widened. A few mortgage bankers discovered the capacity to "monopolize" CMOs (which, under Investment Company Act rulings of the SEC, could only be backed by "whole pool" pass-through certificates) merely by smartly pricing whole pool certificates that they created. This practice converted the benefits of CMOs into a "whole pool premium" which those bankers sought to preserve for themselves.

When the SEC granted a series of "partial pool" exemptive orders (1986-87), that monopoly was broken. Except for a brief problem at the end of 1987 (the stock market crash), we will see that the behavior of mortgage markets was forever changed by the broad-based capacity of market arbitrageurs to create CMOs. After the SEC made the "partial pool" exemption available to everyone (at the end of 1992), the U.S. mortgage market achieved a level of efficiency that is truly miraculous, and perhaps unprecedented throughout financial history.

THE MIRACLES (AND FOLLIES) OF CMOs

What was so incredible about CMOs?

Three charts are attached to show the importance of this invention. Each chart shows payment characteristics of each "tranche" in various CMOs. The first (**Chart 2**) has three classes of securities. This was the first private CMO (June 1983).

The chart tells each investor when it will be paid under various prepayment assumptions. This chart allows responsible disclosure of theretofore unstated risks concerning the timing of mortgage prepayments.

For the first time, investors could openly "partner" among themselves (with the support of a seller who retained only passive subordinate interests and servicing rights) to allocate the prepayment risks of long-term, fixed-rate mortgages. The size of each class, as well as the amount (and value) of retained subordination, were all determined by negotiation relating to the investor's perceived prepayment speed for the pool. Aided by computers and the power of $(1 + i)^x$ (the formula for compound interest), rate and prepayment assumptions determined the price, size and term of each CMO tranche.

Using computer programs that were considered massive at that time, each "tranche" and the seller's retained interest could be sized and valued separately by applying cash flows, at different repayment assumptions, to whatever negotiated pattern results from the investors' and seller's view of present and future investment parameters. What the seller retained when the investor was paid made no difference to investors, as long as sellers' rights could not interfere with the investors' recovery.

After a CMO is closed, changing payment patterns can radically change assumptions, the value of each tranche and the amount of retained residual. As mortgage servicer, the seller can affect those patterns by its servicing and origination practices. As a result, servicing relations must be specified and significantly limited so as to protect investors without impairing the value of the servicing assets and the interests which sellers retain for the mutual benefit of all parties to the CMO.

Each of these CMO charts is referred to as a "declination" or "dec" table. It allows all participants in the CMO to track their investment assumptions through the different rate and repayment scenarios assumed at closing. The calculations behind this table are now the foundation for all "stand-alone" (unguaranteed) multi-class securitizations. The programs cannot "predict" post-closing changes. Those must be negotiated in the complex documents that accompany each transaction. The technology of the dec table, however, allowed creation of multiple-class securitizations (static and rolling) without reliance on future obligations of operating entities to support payments to holders of beneficial interests in the issuing entity.

Most of the "best practices" of the securitization industry arise in transactions such as CMOs. In these cases linkage to the credit of sponsors or sellers generally harms the investment value of a security.

By "true" isolation from a seller, CMOs permit the allocation of funds to one class then another. This allows the sellers and other investors to create "component" interests that absorb certain prepayment risks. Each buys the component which most closely matches its preferred maturity. If the asset payment assumptions at closing continue, after all classes mature, application of the same technology to the remaining assets allows the issuance of new maturities by the seller with equal protection as the initial series.

For mortgages, the yield for each class of investment is set based on a spread from estimated comparable maturity Treasurys. Real "value" is created with a CMO by reducing the variance in spread for each class. That increases the inherent value of mortgages, permitting new loans to be created at rates closer to that of the designated reference security. After 1992, the same technology could be used to create non-mortgage securities, merely by applying different appropriate base references.

In these "dec" charts, investors receive no payments of principal as long as their balance is "100" percent and are paid in full when their balance hits "0" percent. The weighted average life of each "tranche," under various prepayment assumptions, is at the bottom of each series.

By underlining each "100" and each "0," the charts highlight the period during which each class is paid. Using any of the chosen prepayment assumptions, each investor can easily see when its expected payment is to be received. Of course, everyone realizes that actual prepayment speeds will change the payment pattern, often dramatically, over time. The charts, however, give prospective investors, and the seller/servicer, means to negotiate terms that meet each party's expectations as of closing. Future changes are market effects covered by the legal documents to the extent that parties wish to deal with the changes that future markets cause.

The first CMO **(Chart 2)** was a "vanilla" transaction. It was the first private-sector transaction, however, to achieve the "waterfall" repayment pattern that is easily observed by following actual payment flows to each tranche.

The next innovation **(Chart 3)** is a "Z-class" structure that first appeared in September 1983. By this structure, the investor seeking the longest repayment period agrees to "accrete" interest (have its unpaid balance rise rather than receive interest, so the accretion can be used to "turbo" payments to earlier tranches). That "accretion" allows earlier classes to be repaid more quickly or to be made larger. It creates a "zero-coupon" effect for the accreting security, hence the "Z-class" designation, but allows sellers to support far more of the sale price with tranches bearing lower short-term rates, thereby further increasing the amount of investments that can be sold using a pool of assets, increasing the inherent value of underlying assets.

Since accretion of interest without the receipt of cash creates negative cash flow requirements for taxable investors, "Z-classes" are largely instruments bought by tax-exempt entities. Moreover, the instruments create unusual tax consequences for issuers, but those were more than outweighed by the enormous benefits that were enjoyed by the first issuers of these securities.

The advantage of a "Z-class" is mathematical and driven by yields. With more cash to pay early tranches, those tranches are larger. Since short-term rates are lower, profits to the seller increased dramatically with this innovation.

How much profit did the innovators of "Z-class" CMOs enjoy?

It's pretty easy to estimate this. Assuming the four tranches on **Chart 3** were large enough to fund the purchase price of the mortgage assets plus closing costs, and that all mortgage cash flow is allocated to pay the CMOs until all tranches are discharged, whatever is left when the last tranche hits "0" percent belongs to the issuer. Looking at the "Z-class" (B-4 on **Chart 3**), every penny of money that remains unpaid on 30-year mortgages that exist after the "Z-class" is paid represents "profit" to the organizer. The trust holding the mortgage assets for investors in various components terminates and the leftover mortgages can be used by the originator to issue more securities or sold in the market.

Looking at the “zeros” and “weighted average lives” on the bottom of the first “Z-class” CMO chart **(Chart 3)**, is there any wonder why this invention was called “alchemy”? Assuming no prepayments, all the sold components are paid in 17.3 years. At that time, over 75% of the mortgage balances would still be outstanding.

The amount of mortgages remaining after all senior CMOs were paid readily allowed the organizers to resell their retained “seller’s interests.” Since the seller paid all transaction and acquisition costs with proceeds from the sale of senior components and made no commitment to use its own funds to cover any sold securities, the balance recovered at maturity was pure profit. Yet, the transaction was completely consistent with an asset sale.

Those profits fell as more arbitrageurs entered the market. Nevertheless, the enormous initial profits clearly explain why, from about $1 billion in 1983, CMOs fostered a $1 trillion market by 1990 and a $6 trillion mortgage market today.

The instruments have been labeled "Hydrogen Bombs" for outmoded financial markets. By applying market technology, all parties, including consumers and the economy, benefit through the creation of new value using a "normal" yield curve to create enormous profits for all concerned.

In accounting, CMOs exploded a basic axiom that: "One cannot ‘create value’ merely by changing the ‘form’ of a ‘financial asset.’" These charts converted that former axiom into a myth. The CMO touched off a

revolution in accounting because it created need to decide how and when to recognize the undeniable profits that CMOs create.

FASB continues to debate accounting for asset sales. Accountants, moreover, regularly miss the difference between asset subordination (and the inherent need for later "resale") and an agreement to fund losses to investors (creating a present debt). The former is a "sale" while the latter is merely a "reverse" secured loan. Instead of borrowing and pledging assets, the guarantor of a securitization "sells," or induces someone else to sell, financial assets then guarantees that the "purchaser" will fully recover. That creates an "equitable mortgage."

The benefits of "true" securitization certainly created a necessity for accountancy to reflect "true" profits. On the other hand, the follies of "false" securitizations ("equitable mortgages") created nothing but "flimflam" which should not be reflected in financial statements, if they are to be "fairly stated."

Unfortunately, it is sometimes the most sound and liquid entities that are induced to provide guarantees which convert sales into equitable mortgages. In "true" CMOs, liability of parties other than the mortgagors only gets in the way of the "isolation" on which investors rely. In "false" securitizations liability of a highly rated sponsor makes the assets immaterial to investors, permitting the "flimflam" which has now caused us so much trouble.

SEEDS OF THE CRISIS OF 1994

The next CMO "innovation" exemplifies one source of folly. **Chart 4** illustrates a "Planned Amortization Class/Companion Class" structure that was invented in private placement structures shortly after creation of "Z-class" CMOs. A "Planned Amortization Class" ("PAC") is sold to an investor that wants more than the "next-in-line" share of cash flows that the initial CMOs created. This class wants (a) assurance of first priority for payments up to a specified level and (b) to require that other investors receive: (1) no payments until that level is reached, AND (2) all payments above that level, until the "Companion" classes are paid.

Chart 4 shows the result. In the "waterfall" created by underlining each "100" and each "0", the "PAC" classes are assured a narrow range of maturities. Unfortunately, to give the "PAC" this preference, the "Companion" classes must accept all the risk which the "PAC" seeks to avoid.

As a result, "Companion" classes receive nothing when long-term rates are relatively high (when smart investors want to be repaid) and are flooded with cash when such rates are low (when few investors would want payment). In market vernacular, Companion Classes are variously referred to as "Toxic Waste" or "Sucker Bonds."

In the early 1990s, S&P developed a special "r" classification to reflect the volatility of these instruments. Unfortunately, at the time when Companion Classes were being accumulated to create the crisis of 1994, S&P did not rate an estimated 95% of the securities which investors seem to have foolishly acquired and financed without understanding the "toxic" consequences that interest rate increases would soon create.

Once one understands these tables (which appear in all publicly sold CMOs), identifying the "Sucker Bonds" is easy. In this chart, the last two classes have weighted average lives that go from over 20 years to under 2 years (and vice versa) as prepayments cross the "PAC" barrier.

Viewed from the perspective of the early 1990s, when rates were falling, "Companion" classes falsely display the payment characteristics of short-term "current assets." The moment rates moved up, however, those "short-term" assets suddenly become very long term (moving from a weighted average life of around 10 months to more than 20 years in one case shown on **Chart 4**).

This characteristic of Companion Classes "exploded" when long-term rates rose in early 1994 to create a crisis in short-term markets. Some money market funds had to call upon managers for support to avoid "breaking the buck." When issuers of commercial paper to money market funds foolishly relied on the short-term nature of Companion Classes to support their own paper (or loans to others), calamity occurred as the Fed raised rates to "discipline" the folly of their speculation.

It was all logical by the magic of CMOs, but let's come back to this later.

1988-1992

MORTGAGE MARKETS MATURE WHILE CORPORATE MARKETS LAG

Chart 5 brings mortgage and corporate markets together and links those debt markets to equity markets (the S&P 500 Index), during three separate periods between 1988 and today.

1988 to 1992 is the time of period "A" on **Chart 5**. As a result of problems observed during this period, the SEC enacted Rule 3a-7 under the Investment Company Act of 1940 at the end of 1992, opening the "Goldilocks Era."

The green line (along the bottom) tracks the same spread as **Chart 1**, picking up where Chart 1 ends. Note that mortgage spreads rose as the government began to shut down hundreds of S&Ls during the 1989 S&L crisis. Apparently to reduce the impact of widening spreads on corporate borrowers, in 1989 the SEC permitted banks to create off balance sheet conduits to make corporate loans that would evade capital requirements that Congress mandated to fix the S&L scandals of the 1980s. That effort, however, failed to contain the cost of liquidity to growth firms. In short, it didn't help the corporate economy.

There was a small rise in mortgage spreads when Iraq invaded Kuwait. The effect of invading Kuwait on mortgage markets was almost miniscule, however, compared to what happened to corporate bond spreads for growth companies in 1990 (the red line).

The effect of widening corporate spreads on stock market prices in 1990 (the blue line) is understandable. Rising corporate spreads decimate future expected earnings of affected corporations, justifying a plunge in stock prices. When all unrated corporations (less than 5% of firms are "highly rated") are affected simultaneously, the stock market will almost certainly fall. Some say vice versa is also true, and that this is "merely a chicken and egg" relationship. To "win" at chicken farming, however, one needs <u>both</u> chickens and eggs. Therefore, whichever effect triggers the other is a fool's debate. Both markets must be positive for economic success.

By 1990, the SEC became justifiably concerned with how poorly corporate markets performed in comparison to mortgage markets. Corporate debt markets "imploded" during 1990 despite granting banks the unique capacity to fund corporate debts off balance sheet, through nominee "multi-seller conduits," where the sponsoring bank guaranteed all loss to the investors in the conduits' commercial paper.

The performance of corporate spreads during period "A" amply demonstrates the failure of conduits to produce liquidity at competitive prices. This same pattern, it may be noted, repeated after 1998.

In 1990 and 1991, when mortgage market lawyers were asked to explain the difference in performance between mortgage and corporate markets, the main responses were (1) lack of shelf registration capacity and (2) lack of the exemptions which freed many participants in mortgage markets from the needless restraints of the Investment Company Act of 1940.

At the end of 1992, the SEC enacted Rule 3a-7 (and the requisite shelf registration rules). The impact on mortgage, corporate bond and stock markets is shown in period B. The result was almost astonishing.

Only those who understand the benefits of CMOs and the riskless arbitrage transactions that these changes permit could have predicted this result.

1993-1998

THE "GOLDILOCKS" ERA

Enactment of Rule 3a-7 fostered a financial miracle during period B on **Chart 5**.

In early 1994, "Companion Class" speculation exploded in the hands of certain mutual fund and hedge fund managers (*e.g.*, David Askin and Piper Jaffray). However, neither corporate nor mortgage markets suffered material harm, in aggregate. Having been fooled once, moreover, investors did not, it appears, repeat that mistake following the 1994 demise of Kidder Peabody. When period B on **Chart 5** is compared to period C, it is clear that we now need all the benefits of period B for economic recovery.

In 1997, the "Asian Contagion" caused panic in almost every corner of the world. U.S. stock markets were impacted significantly, but only for a short time. When viewed from the outside, period B shows that markets for U.S. corporate loans merely yawned and moved on. Soon, our stock markets recovered.

Period B illustrates the impact of truly free financial intermediation. As arbitrage procedures for corporate markets matured, corporate spreads (and variance in those spreads) narrowed for more than five years. During the crisis of 1990, corporate spreads "spiked" more than 3.5%. That never happened between 1993 and 1998.

In early 1994, spreads narrowed, then settled at no change. In 1997, risk spreads narrowed in the U.S. while much of the rest of the world was in crisis. By April of 1998, pricing spreads from the base securities for mortgage and corporate debt arbitrages converged at around 150 basis points. For mortgage markets, spread held nearly flat for eight years. For corporate bonds, the contraction of spread between 1990 and 1998 was more than 8%. No wonder we call this the "Goldilocks Era" of finance.

Why, "just when you thought it was safe to go back in the water," did a "virus" infect markets and destroy all the efficiency which had been created over a period of more than five years?

To understand what happened in 1998, we must first look at what Rule 3a-7 allowed corporations and investors to do with CMO technology during the "Goldilocks Era."

THE RULE 3A-7 EFFECT ON CORPORATE MARKETS

At the end of 1992, several of the world's largest corporations were trying to overcome the detrimental effects of the spread spike triggered by the S&L crisis and the Kuwait war (see period A on **Chart 5**).

The only means for corporations to gain direct access to secondary markets for sales of assets, however, was through cumbersome vehicles that could not be priced or sold with anything like the efficiency of mortgage-backed securities.

Within weeks after Rule 3a-7 was adopted, a major automotive manufacturer sold over $1 billion of securities backed by retail auto loans at a considerably narrower spread to Treasurys than had previously been achieved. **Chart 6** shows how that deal brought the technology of CMOs to assets created by the sale of manufactured goods.

Each class of these securities was paid in full within five years and qualified as "current assets" to support commercial paper. With the benefits of CMO "tranching," these securities were more desirable investments for all sorts of intermediaries. They had none of the "Toxic Waste" characteristics of the "r class" CMOs which "exploded" in 1994.

For the seller, the ability to support a large part of its investment in financial assets by the sale of assets to a structure using notes with shorter maturities (and lower yields) made the transaction very profitable.

The benefits of this transaction were tiny, however, compared to what that same seller achieved less than two months later, when the transaction described on **Chart 7** was completed.

This time, the seller created securities with "bullet" maturities that qualified for sale directly to money market funds. Few prior securitizations ever achieved this level of certainty. The transaction permitted disintermediation on a broad scale using CMO technology in a corporate context.

In mortgage transactions, absent prepayments, there is so little principal available in the first year after origination that the creation of hard "bullet" maturities saleable to money market funds cannot easily be justified. Moreover, prepayments occur so much more frequently on mortgage loans (and with enormous variance), so rating agencies would justifiably be concerned that a shrunken pool of mortgage loans might suddenly stop prepaying, leaving insufficient normal loan payments to cover "bullet" securities payable in the first year or so of a term mortgage structure.

For a large pool of retail auto loans, the transaction described in **Chart 7** created a "miracle." Not only did the ability to directly access markets create a far more efficient and profitable sale, but it opened a new market by allowing reluctant money market funds the chance to directly participate in the seller's securitization structure.

This transaction was rated AAA and priced at considerably narrower spreads than had ever been achieved before for this asset class. Moreover, it was priced on the same day as the second of two major rating agencies lowered the rating on the seller's unsecured commercial paper to a level that was not suitable for investment by certain money market funds.

Funds that bought the "bullets" apparently noticed that this transaction assured the seller direct capacity to access money market funds. With a significant spread difference between the "bullets" and the seller's lower rated unsecured paper, money market fund managers realized this transaction substantially reduced risks of the seller's unsecured paper. The seller could create asset-backed securities at prices that would allow full repayment of its unsecured paper. Thus, the higher yield on unsecured paper made it a bargain.

Soon, to the surprise of many, at a point when advisors had been telling the seller that no issuer had ever sold more than $4 billion of lower-tier commercial paper, the firm suddenly had little problem keeping more than $10 billion outstanding.

As with the transaction on **Chart 6**, non-"bullet" tranches were all desirable to intermediaries who used them to support commercial paper sold to money market funds. The market-opening impact, however, was that the transaction on **Chart 7** allowed issuers and money market funds to interact directly, rather than through entities controlled by regulated intermediaries.

The transaction was backed entirely by the credit of many thousands of U.S. consumers. Thus, it posed no credit concentration risk to investors in money market funds. Unlike transaction structures where investors rely on guarantees and future obligations of a particular seller or sponsor, because the seller had been downgraded, the credit of the deal relied entirely on the underlying assets and protection created by legally subordinated interests in those assets.

With no increase in risk to investors, the transaction described on **Chart 7** was instrumental to:

(1) Bring CMO technology of mortgage securities to corporate enterprises to directly support their sales finance;

(2) Lower the rate at which corporations could fund third-party sales;

(3) Provide alternate liquidity to one of our largest enterprises in a time of need that had been generated largely by the national and international needs of the nation; and

(4) Open a new era where riskless arbitrage transactions, engaged in by conservative, unregulated entrepreneurs, could effectively compete with regulated intermediaries and issuers of highly rated corporate debt.

The benefits are evident on graph B of **Chart 5**. Between 1993 and 1998, as arbitrageurs became increasingly effective at creating transactions to acquire unrated obligations and fund their purchase by selling highly rated component interests in those assets, corporate spreads declined by more than 50%.

By 1998 illiquidity was a matter of "transaction cost," not a systemic or investor-perceived "risk" that a future crisis would occur. Money market funds no longer had to compete by offering "gross" rates to conduits that largely reflect the "net" cost side of their regulated sponsors (the fundamental source of the problem now faced by money market funds in the U.S. and Japan).

In the "Goldilocks Era" of 1993-1998, losses that arose in the "break-the-buck" crisis of 1994 were absorbed (as they should be) by investors and advisors that somehow came to believe that low (and falling) long-term interest rates fostered by the Fed would be permanent. Owners of Kidder Peabody could not recover loss from those to whom they sold (then financed) a large volume of "Companion" class ("Toxic Waste") CMOs. Having suffered such losses, however, they were unlikely to repeat that mistake. By isolating that loss while permitting intermediation to continue free of interference, corporate and mortgage markets suffered little systemic harm from the 1994 or the 1997 crises, and certainly nothing by comparison to what markets have been through since 1998.

Then, in 1998, just as we were celebrating our success, Russia's default on bonds created the "Hedge Fund Crisis."

How could default by one issuer, a nation with whom (it has been noted) the U.S. had less trade per year than it had with Canada in a day, create a crisis that caused the spread on U.S. corporate bonds to widen by more than 3%? That level of widening, at a 20 to 1 price/earnings ratio, represents a roughly $1.8 trillion stock market impact. Russia defaulted on only a few billions of debt.

At the time, senior U.S. government officials called this the worst disconnect they had ever seen between corporate finance markets and the "real economy."

Few have noticed, however, that in the two months before Russia's "default," corporate spreads had already risen to levels not seen in the prior 18 months. Did markets "predict" the default?

Unbeknownst to many (including, it now appears, several Nobel laureates), the SEC enacted a rule, effective July 1, 1998, that restrained the ability of arbitrageurs to create the riskless arbitrage transactions which had supported the "Goldilocks Economy" for five years. This rule logically explains the crisis that followed (and its resolution).

THE "10% OBLIGOR CRISIS" OF 1998

How could a seemingly innocuous change to Investment Company Act Rule 2a-7, effective July 1, 1998 (that nobody but a few short-term debt traders even noticed), cause the largest corporate debt crisis in eight years and destroy the virtuous cycle of liquidity that supported our "Goldilocks Economy"?

Consider the aggregate consequences that arise over the next four years, as one follows the red line across graph C on **Chart 5**. By the end of the third quarter of 2002, spreads had widened so far that unrated "growth" companies would need to pay about $170 billion per year more in interest (relative to AA-rated firms). At a price-earnings ratio of 20 to 1, that implies a reduction in the value of corporate equities totaling $3.4 trillion. Not surprisingly, a noted Wall Street economist, Larry Kudlow, has reported that stock markets fell by the same amount ($3.4 trillion) during that period.

There are numerous "causes" of corporate spread "spikes." What we know is that once something "triggers" the process of rising spread, a liquidity crisis often feeds on itself. As investors seek higher yield, the risk to those paying the higher yield increases, leading to still higher yields.

This process can be broken when markets are open and competitive. "Good" borrowers will not be required to pay higher spreads associated with "bad" borrowers if competition exists. When competition is restrained, however, a spiraling crisis often follows a period of disruption.

There was no U.S. macroeconomic trend which explains the spike in corporate spreads in 1998. Moreover, except for the spike associated with the events of 9/11/2001, none of the corporate spikes shown by the red line on graph C of **Chart 5** is readily explained by macroeconomic trends (though they have now, quite logically, created a macroeconomic environment that is quite unhealthy).

At a transaction-by-transaction level, the effects of amendments to Rule 2a-7, and its consequent impact on market reform efforts, can explain virtually every change in trend noticed on graph C. Between 1993 and 1998, transactions like those on **Charts 6 and 7** were properly created to support virtually every conceivable type of corporate debt obligation. In some cases, these new tools were abused and that required appropriate reforms, if markets could not be self-correcting.

The "10% obligor" rule was directed, however, at problems of 1994 that had little impact on broad markets. What properly should have been regulated was the use of "Companion Class" securities (see **Chart 4**) as "current assets" to support the sale of commercial paper, not a general limit on "large" SPEs. That would have restrained the two volatile classes of securities shown on **Chart 4**. Instead, however, the "10% obligor" rule restricted indirect access to money markets for all classes of securities shown on **Charts 2, 3, 4, 6 and 7**.

The Companion Class "mosquito" that bit markets in early 1994 was already "dead." So, the 10% obligor rule had the impact of using a "howitzer" to shoot a dead mosquito. The collateral damage far exceeded the benefits.

For example, during the mid-1990s, a real estate investment trust (REIT) made loans across the country to small businesses. It could gather 100 such loans to create a highly liquid and well-diversified pool of loans. The pool would sell highly rated components suitable as "current assets" to entities that funded themselves by selling commercial paper to money market funds.

As funds warned conduits that they would not allow "10% obligor" assets, conduits to which that REIT sold assets suddenly switched from wanting large (diversified and liquid) pools to demanding separate pools for each loan, at a prohibitive structural cost.

That REIT, along with many other legitimate businesses, was forced to abandon its primary market for liquidity. As spreads rose, issuers and money market funds found no effective means to interject competition into corporate debt markets at the "short" end of the yield curve. As a result, spreads spiked.

The crisis of 1998 abated only when the SEC's staff wisely issued a no-action letter that exempted securities issued before July 1, 1998, from the 10% obligor rule. Prices for exempted securities rose immediately and spreads fell.

Old securities, however, cannot support markets for new loans. As grandfathered securities matured, a new crisis hit, in the fall of 2000. This crisis (and others that followed) was triggered by efforts to reform accounting for securitization, but the spiral triggered by FASB was perpetuated by continuing restraints of Rule 2a-7 on the ability to create new riskless arbitrages.

FASB tried, in September 2000, to correct accounting practices for "multi-seller conduits." With no meaningful capacity to compete for corporate funding using riskless arbitrages, when conduits liquidated

loans to avoid increasing costs of capital, spreads once again rose dramatically (by about 250 basis points). This created a crisis that only abated when FASB backed off and the Fed began its series of 13 rate reductions.

In 2002, FASB again sought to require consolidation of various types of "straw-man" entities. Again, with no meaningful competition (due to the SEC's restraint on riskless arbitrages), the effect was a sharp spike in spreads.

With limited access to short-term sources of cash, transaction-motivated entities soon converted to "synthetic" structures using various types of swaps. We are just now beginning to see the dangers of issuing contracts to accept risk on corporate debt without an efficient market to price the underlying debts themselves. Warren Buffett recently characterized "mark-to-market" requirements for valuing derivative securities as "mark-to-myth."

Today, with money market funds being restrained from direct access to corporations through arbitrageurs, we are facing new prospects for a Japan-style "break the buck" crisis.

Each crisis since 1998 can, by a logical and sequential process, be related to the interplay between market functions and competition, even the market crisis after 9/11. Without free capacity of market-makers to use the benefits of Rule 3a-7 to create effective competition in corporate finance, markets for corporate debt devolved upon a small group of very large investment entities. Worse yet, through failed reforms and the application of ill-conceived and inappropriate advantages granted to those institutions, the market dominance of these entities has reached a point where it may be true that only by unlocking control can we ultimately save those institutions themselves.

THE MARKET EFFECTS OF CMO TECHNOLOGY AND INTERFERENCE WITH ITS BENEFITS

Chart 8 uses the blue lines from **Chart 5** (performance of the S&P Index) to highlight 15 periods of market disruption since 1988:

1. In 1989, Congress finally began to shut down the "Zombie" S&Ls that so badly undermined our economic health. This generated a crisis in spreads (as expected). Liquidity, however, was preserved (at a price) by an SEC accounting proclamation that seemingly supported the creation of conduit "nominees" of major banks that funded corporate debt "off balance sheet." The stock market rallied, perhaps because faith in the government to deal with a crisis outweighed the negative impact of wider spreads.

2. The invasion of Kuwait by Iraq led to a spike in spreads and a sharp drop in equity values. This is the logical and very normal "inverse correlation" one would expect. As rates paid by a growth company for debt rise relative to highly rated competitors, that company's growth (and stock value) will most likely be impaired. Thus, stock values normally fall as the relative cost of funds to growth companies rises. Confidence restored by "Desert Storm," and markets refreshed by RTC's capacity to liquefy the assets of closed thrifts (often by the use of securitization), restored markets over time.

3. In 1992, we were coming out of the crises of 1989-91, but many corporations were effectively "hobbled" by a weakened economy and the high cost of debt they needed to incur during the preceding crises. Stock prices "waffled" as competing hopes of recovery and fears of a new crisis made investors uneasy. This ended as debt markets settled down and preparations for Rule 3a-7 opened new market opportunities.

4. The "Break-the-Buck" crisis of 1994 ruined Kidder Peabody and many other bond market participants. The effect on stock markets was significant but short-lived. With effective direct intermediation in place,

corporate spreads narrowed while mortgage spreads widened a bit (as speculators of the early '90s were replaced). Changing the identities of intermediaries has little real impact on markets as long as new value can be created for investors.

5. The "Asian Contagion" had an initial effect on U.S. stock markets, but they quickly recovered as investors realized the U.S. markets had become a haven for free intermediation while other markets were abandoned. Mortgage spreads held constant while corporate spreads narrowed.

6. This is the "Hedge Fund Crisis." Markets "tanked" as a fire sale of corporate and mortgage debt securities led to a calamitous rise in spreads. The crisis ended when the Fed lowered rates and the SEC provided no-action relief that allowed investors to repurchase (at much lower prices) securities they had been forced to divest in order to meet a July 1, 1998, effective date for amendments to Investment Company Act Rule 2a-7. Though the staff of the SEC did all it could, market observers realized that lack of "forward" relief would eventually cause another "panic" as grandfathered securities died off and the illiquidity fostered by the 1998 rule changes reoccurred.

7. The first reoccurrence of the 1998 "virus" happened in 2000. Mortgage markets spiked in the spring. This coincided with the first drop in the stock of high tech firms.

When viewed in perspective, the effect of high spreads since 1998 would induce corporate entrepreneurs to turn to stock markets to liquidate their holdings before the effects of rising debt costs would become apparent in financial results. Bankers, deprived of debt market arbitrage profits, would likely accommodate those sellers, to assure fees. When a "feeding frenzy" followed, everyone "rushed to sell" into a rising market. As the Fed raised rates and mortgage spreads rose to accelerate the effect, the frenzy stopped and the "bubble" burst.

In September, corporate spreads spiked as FASB announced its intent to consolidate "straw-man" conduits and sponsoring banks "panicked." Again, Rule 2a-7 got in the way. Trying to sell corporate debts without arbitrageurs to make a market was like the Hunt brothers trying to sell their hoard of silver after they had cornered the market.

The calamity of error only stopped when the Fed began its aggressive rate cuts and FASB temporarily "backed down."

8. At the beginning of 2001, after FASB temporarily retracted its consolidation project, a "glitch" developed in the implementation of FASB's new standard that applied to "true" securitizations. A participant in the market for commercial mortgage-backed securities became convinced that restraints on sales of assets would disrupt that market and distributed an article that generated a minor panic. Corporate liquidity depends on access to commercial mortgages and other markets. Corporate spreads widened and the stock market fell in tandem.

This reversed when FASB clarified its procedures and "CMBS" markets reopened. Again, Rule 2a-7 appeared to block arbitrages.

9. A while later, FASB was advised that various bank credit card programs could not comply with its new standard for asset sales because the banks retained the right to redeem the sold assets, a right FASB properly associated with a secured borrowing.

FASB gave banks time to bring programs into conformance and markets recovered.

10. This is the crisis triggered by the events of 9/11/2001. It is the first "external" crisis to hit markets since Iraq invaded Kuwait. Despite devastation of market structures, by the concerted efforts of all involved parties, markets quickly recovered.

While a tragedy, this crisis shows how rapidly markets can recover when people are focused on crisis resolution. It occurred in the midst of a far more complex situation, the resolution of which we are now seeking to find.

We had far greater success overcoming the effects of "evil," as observed on 9/11/2001, than we have had overcoming the effects of the market "folly" which has now restrained corporate markets for nearly five years.

11. At the end of 2001, the stock market began to fall in response to corporate scandals revealed following Enron's bankruptcy filing. These scandals overshadowed markets from early 2001 (when new FASB rules forced disclosure of some Enron structures). Enron's December 2, 2001, bankruptcy filing was followed by substantial volatility in stock markets, then by a recovery in 2002 when new SEC rules on disclosure took effect.

It is interesting to note that corporate bond market spreads improved substantially between the date of Enron's filing and the second quarter of 2002. Perhaps bond investors found yields attractive relative to stocks. Perhaps they felt reform would ultimately benefit markets. In any event, spreads and stock markets reacted very differently to the news of major scandals.

12. This stock market decline, through the third quarter of 2002, coincides in a nearly perfect inverse relationship with rising spreads. The cause of rising spreads can probably be seen in a table that *The American Banker* published April 15, 2003. As the economy was struggling to recover from a downturn, America's largest 25 bank and thrift holding companies were shrinking their commercial and industrial loan portfolios at a fairly alarming rate. Total lending was 16% higher at September 30, 2001, than at September 30, 2002.

Worse yet, that table showed that 94.5% of the decline occurred at only 7 of those 25 companies. Those 7 held, on average, over 25% more of those loans at September 30, 2001, than at September 30, 2002. As the largest loan syndicators, moreover, loans they "dumped" were probably syndicated to others among the top 25. As a result, the seven may actually have created more than 100% of this shrinkage.

With that sort of mass abandonment of corporate lending, it is easy to explain both the enormous rise in spreads and the $1.9 trillion loss of market value that investors suffered during the third quarter of 2002. By comparison, the effect of 9/11 was quite small. If arbitrageurs had been able to more freely disintermediate to money market funds under Rule 2a-7, would this have been a crisis or a pricing opportunity?

13. In January of 2003, concerns arose over U.S. bank involvement in "credit default swaps." A rating agency studied the situation and found that U.S. banks were net "buyers" of protection. With those losses shifted, at least for now, markets soon recovered.

14. In May of 2003, markets responded to the Fed's growing concern with the possibility of "deflation," a phenomenon with which U.S. investors and consumers have not contended since the Great Depression. Subsequent actions by the Fed seem to have assuaged many investors' fears, at least for now.

15. This brings us, finally, to "the crisis yet to come." A recurrence of any of the recent crises could, of course, occur unexpectedly. For now, however, the next crisis appears to be the one generated by having interest rates that are too low, with markets that seem unable or unwilling to expand.

For growth-oriented corporations, with capacity utilization rates below 75% and spreads still above 300 basis points, it is easy to see why there is reluctance to borrow.

Some firms find low current rates a time to borrow and fund future pension costs. It is, however, a combination of low rates (causing the present value of future obligations to rise) and poor market

performance (depleting the value of investments that support those obligations) which is causing the pension plan problem.

After 13 tries, the Fed now appears to be essentially "out of ammunition" to use the Fed Funds rate as a means to stimulate growth. With significant restrictions on direct access to corporate securities, and growing restrictions on the issuance of asset-backed securities that bypass regulated entities (from the SEC and FASB), money market funds are close to being placed in a "liquidity trap."

With all the restraints, the source of their assets is restricted largely to funding bank conduits. With those, the bank makes its money from sources over and above the funding cost paid to funds. Managers of money market funds who cannot "disintermediate" around the banks and their conduits have to take their fees from yields paid to customers.

As a result, funds are being caught in a "death spiral," where the need to pay fees makes it economically impossible for money market funds to compete with bank accounts.

REFORMS: CMO TECHNOLOGY MUST THRIVE

All nine of the crises which have occurred since 1998 would have been alleviated, at least in part, by a more enlightened SEC policy under Investment Company Act Rule 2a-7 and more effective implementation of FASB reforms.

This is <u>not</u> to criticize the SEC or FASB, however. These problems are very complex and sometimes completely baffling. In 1998, the SEC staff quickly realized there was a problem with the Rule 2a-7 amendments and did all it could to resolve the issues. Putting together the necessary pieces for proper reform of that amendment required time so that implementation would not create more problems.

It now appears, however, that Rule 2a-7 should be revised to:

(1) allow funds more access to well-structured and properly diversified asset-backed securities and

(2) encourage diversification of money market fund investments into assets that disintermediate the funds' investments to avoid risk of a "break-the-buck" competitive "death spiral" with banks that compete "net of costs," while the funds must offer gross rates and take their costs out of money payable to investors.

Both of these enhancements would be positive for funds, fund managers, investors, and the general economy. Even banks, who cannot profit, in the end, except from the profits of their customers, would benefit by this.

By opening markets so that money market funds can take fees from a risk-free part of the spread banks charge growth companies, rather than the 100 basis points between Fed Funds rates and 0%, competition in corporate finance markets can be saved.

In the end, that's the undeniable "good" that CMO innovations of 1992/1993 (which opened the "Goldilocks Era") brought to U.S. markets.

In the work of FASB:

(1) Accountants and the board must learn the difference between rights and obligations that create "debt" and those that do not.

- Where a party only holds subordinate interests in debt obligations and manages only the liabilities of an entity, it has not created its own debt and the assets/liabilities of the issuing entity should not be consolidated. As a legal matter, all the manager can do is protect senior investors by protecting itself. It cannot sell assets to speculate and create profit. When it makes wise liability selections, it is only doing what senior interests want, increasing their protection. The seller/servicer must sit by until all senior interests are paid to re-collect what's left. That has always been part of the "magic" of CMOs.

– Where a party manages liabilities backed by debt obligations and agrees to pay any shortfalls, that's a debt of the manager/obligor. In this case, the manager can speculate with liabilities, because investors look to the manager's separate balance sheet to pay up when errors occur.

THERE IS NO DIFFERENCE IN THIS RESULT BASED ON THE MATURITIES OF LIABILITIES. CMOs always return assets to creators when senior interests are paid. Those rights are never sold or accounted for as sold. The term of the senior interest is irrelevant, as long as it is a properly isolated and fully transferable "component" interest that does not depend on future payment obligations of the manager.

(2) Fee income that is terminable at the will of unaffiliated investors is not a right of an investor and should not be a "variable interest." The fees, as Statement 140 properly notes, are merely benefits of servicing, earned by performance, not held as a right. Consequently, as FASB has drafted FIN 46, managers of "registered investment companies" do not consolidate due to a scope exception, but those that are not registered can be required to be consolidated with an asset manager. That's absurdly bad policy. Assets should not be consolidated with institutions that merely manage them for a fee where investors can terminate their services.

(3) When parties "borrow" the borrower owns collateral and the lender owns a loan secured by the collateral. "Sellers" of assets, like borrowers from banks, never retain interests in the financial asset components that they "sell." When a sale is properly recorded under Statement 140, what the buyer buys is a "component asset" in which the seller does not retain any interest. The component, and risks associated with its ownership, lay entirely with the buyer. If a seller retains a subordinate interest in the asset from which that component arises, it will lose 100% of that retained interest before the component buyer suffers any loss on its component. When the seller's retained interest is gone, then and only then does the buyer's loss begin and the seller's loss stops. There simply is no overlap. Sellers, therefore, retain none of the "risks" of the components owned by purchasers.

The FIN 46 terms which suggest that sellers have retained interests in sold components create a situation where investment becomes impossible. Sellers cannot rely on a commitment to fund from a conduit where circumstances will cut off the commitment based on the size of the conduit's portfolio.

Thus, this term creates illiquidity at the very time it may be most necessary and further fosters a monopoly of credit by requiring sellers to deal only with very large conduits. This, therefore, creates a hurdle to markets with no foundation in logic, law, economics or accountancy.

FASB has generally done an admirable job molding policy to fit market needs. Its efforts at reform, however, must continue until they have the process "right." We will know when that happens by the way markets react.

In the fall of 2002, it finally became clear that FASB would seriously try to force the closure of various loopholes that had been created in GAAP. That may not succeed, but since then spreads have narrowed more than 400 basis points. It is essential that sales of financial assets be recognized (remember the Depression-era consequences of precluding sales). It is also essential that transactions by which sellers (and others) agree to fund shortfalls in the ability of assets to support component securities must be recognized as "debt," not as sales.

If somebody "sells" an asset then agrees to pay any deficiency in the debt supported by the asset, the "buyer" is no more than an equitable mortgagee (a creditor of the seller, secured by the assets, in every respect except "form"). The transaction is an "asset securitization" only in form.

It is the affirmative obligation to pay loss to others which converts an otherwise properly subordinated "component interest" in sold assets into a "liability." An interest which supports a component sale exclusively by subordination (or the access to future benefits of servicing) preserves to the seller no unknown future liability, only a mandate to reprice the asset that it retains periodically, to reflect its value.

A seller with only interests through subordination, that services or manages component assets sold to others, only has capacity to affect the value of what it never sold (its retained interest). Where there is a duty to pay cash in the future, however, senior interests are invited to rely on the obligor for recovery of loss. In the former case, the one taking actions has no ability to cause harm to other investors, but in the latter case it is given the same "rights" to generate loss to lenders as a simple borrower.

Where a future payment obligation of the manager exists, component buyers grant the manager "discretion" based on other assets of the manager. Without an affirmative payment obligation, component holders are constrained to reliance on assets previously isolated. The manager can only be compensated from the same assets, thereby aligning the manager with the interests of investors.

Consequently, where no future payment guaranty exists, holders of components of the sold assets may change based on choices made by a servicer which are fully constrained by the combined relationship of the assets to all investors that remain. This is the ultimate mathematical constraint of CMO technology. The investors remain fully capable of selling their components without reference to liability of the pool manager, so it is truly a "sale" of components, not a debt.

The fact that parties may benefit or be harmed by the interaction of external events with a securitization structure is inherent to all CMOs. That's why tables which describe CMOs show various repayment assumptions. FASB must create a base for level competition and consistent accounting, but it must not lose sight of the "axiom-breaking" CMO which necessitated the reappraisal of all accounting in this field.

The SEC, in adopting reforms to Rule 2a-7, should be concerned with concentration of risk whenever there is a party that both manages and guarantees liabilities of a special purpose entity, but it should not be concerned where someone only manages a diverse pool that separately supports liabilities to investors and subordinate rights of its own. The first case involves a nominee-agent of the manager, while the second entity is independently supported by separate assets.

Thus, reform from the SEC perspective can effectively open markets: (1) by making the 10% obligor rule apply only to cases where abuse is possible and (2) by precluding arrangements that allow entities to concentrate risk to the detriment of investor safety. By these reforms, investors, borrowers and those who are now "advantaged" will all benefit.

Reform from FASB must constrain abuses where assets are "sold" by creating liabilities that are guaranteed by the manager or seller. Those reforms must, however, allow all of the technology based on CMOs to thrive. That can only occur if CMO technology is allowed to access the full range of investors (short-, medium- and long-term).The common "thread" for FASB is clear. Where "assets" support investors and CMO technology is properly applied, management of maturities is not an issue. The investors will force terms that significantly limit and entirely specify the manager's creation of new maturities. Where future payment obligations support a
transaction, or investors are restrained from trading what they "buy," there has been no "sale."

In finance, it is only when there is an absolutely "level playing field" that money can freely flow from less advantageous uses to more advantageous uses.

With proper reforms from the SEC and FASB, we can recover from the devastating economic consequences of the past five years, though it will take time.

Frederick L. Feldkamp

is a partner in Foley & Lardner's Chicago office, where he is a member of the firm's Business Law Department and Finance Practice Group.

In 1973, Mr. Feldkamp provided the legal basis for Foley & Lardner's pioneering bankruptcy opinion that permitted issuance of America's first rated private mortgage-backed security in the post-Depression era. Throughout the years, he has provided creative legal advice to support numerous securitization innovations, including:

- Creation of the largest foreign-owned Japanese mortgage service firm, through sponsorship of the largest non-bank financial-institution reorganization in Japan (2000)
- Utility transition securities, including the largest ABS offering of 1998
- The first private collateralized mortgage obligation (1983)
- Exemptive proceedings permitting several firsts, including grandfathering under rule 2a-7, home loan conduit, and partial pool CMO

His practice includes counseling U.S. and multinational corporations, international financial organizations, domestic and foreign regulatory agencies, and self-regulatory organizations on a variety of financial services matters. Mr. Feldkamp has consulted on projects to enhance legal, regulatory, and accounting rules to facilitate securitization in countries throughout the world.

Other areas of Mr. Feldkamp's practice include representation of financial service companies on all aspects of business, including corporate law, mergers and acquisitions, regulatory and operational matters, workouts, reorganizations, and bankruptcy matters. In addition, he has been involved in numerous bank, thrift, and finance company restructurings. He has advised on highly leveraged bond transactions, including procedures to assure legal compliance, and as counsel in proceedings to unwind and reorganize highly leveraged issuers.

In addition to his numerous publications (listed below), he was the contributing author for legal issues affecting AU 9336 published in October 2001 by the Auditing Standards Board of the American Institute of Certified Public Accountants. The audit guidance applies to any legal opinion that may be required to support accounting sale treatment for the transfer of financial assets by U.S. firms. Mr. Feldkamp has also presented numerous speeches on U.S. securitization issues for the American Law Institute, The World Bank, the People's Republic of China, and for banks, investment banks, and banking and other regulatory groups in the U.S. and in countries throughout Asia.

Mr. Feldkamp graduated from The University of Michigan (J.D., *magna cum laude*, Order of the Coif, 1971; A.B., economics, with distinction, 1968) and was a student fellow on the Research Seminar in Quantitative Economics. He was the legal profession representative invited to serve on the FASB 140 Audit Issues Task Force of the American Institute of Certified Public Accountants.

Publications

Author:

- "*Saving Private Intermediation,*" Structured Finance Yearbook 2001 (supplement to International Financial Law Review), October 2001
- "*U.S. Developments: Protecting Goldilocks from the Bears*," The ISR Legal Guide to Securitisation, International Securitisation Report, July 2001
- "*Asset Securitization: The Alchemist's Dream*," Securitization Yearbook 2000 (supplement to International Financial Law Review), September 2000
- "*U.S. Developments: What is Menacing the Virtuous Economy?*" The ISR Legal Guide to Securitisation, International Securitisation Report, July 2000
- "*Securitization Developments: United States—It's Moving the Cash Flow—Stupid*," Securitization Yearbook 1999 (supplement to International Financial Law Review), September 1999

Co-author:

- "*Rethinking the Role of Recourse in the Sale of Financial Assets*," The Business Lawyer, Volume 52, No. 1, November 1996

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ATTORNEYS AT LAW

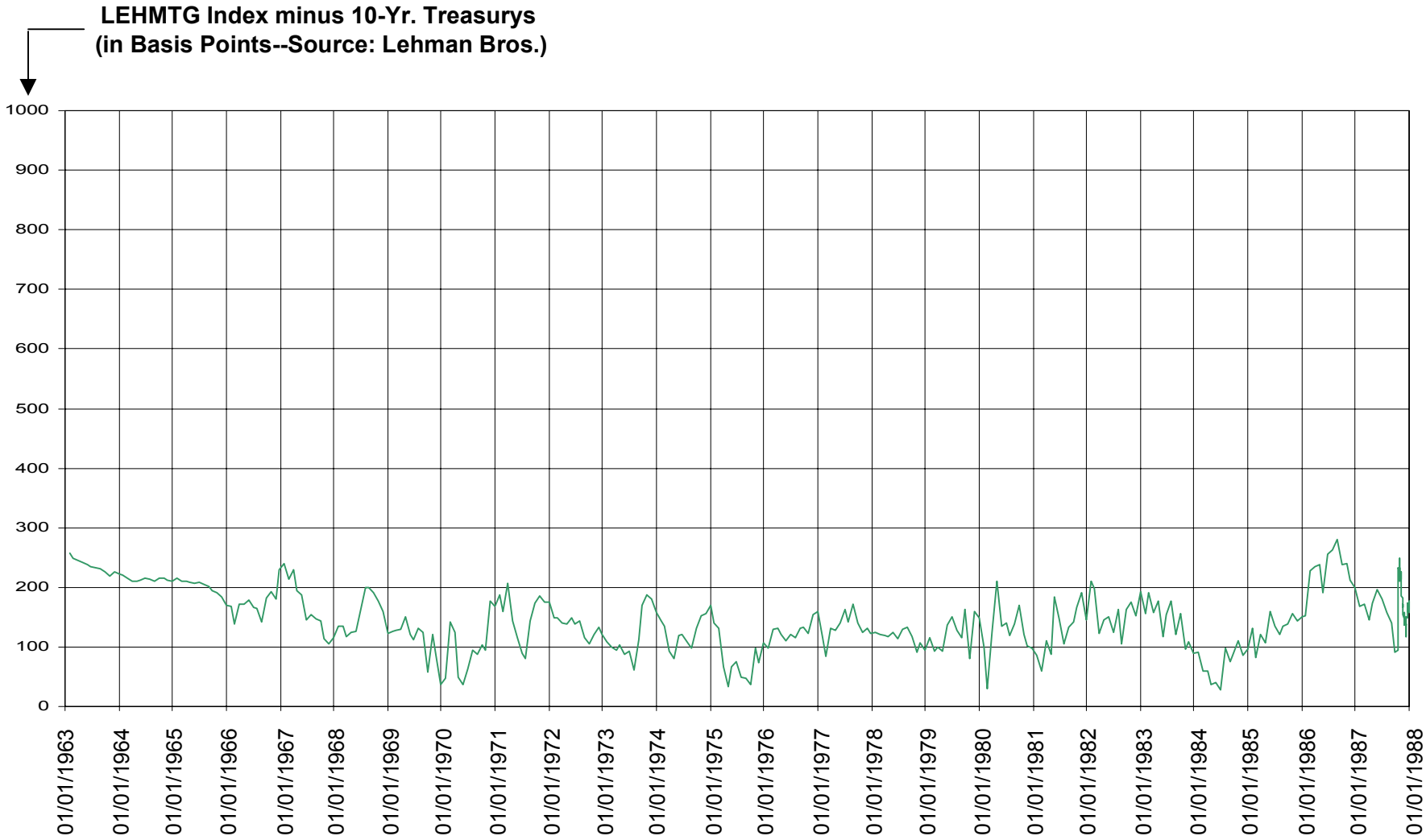
Charts to accompany:

"Who Let the Bears Kill Goldilocks? Can we save U.S. corporate finance from its next crisis?"

By Frederick L. Feldkamp
July 14, 2003

CHART 1

MORTGAGE SPREADS
(1963 - 1988)



FIRST SEC-REGISTERED CMO -- June 1983

CHART 2

Percent of Initial Principal Balance Outstanding for:

Payment Date	Class A-1 Bonds at the following percentages of FHA Prepayment Experience:			Class A-2 Bonds at the following percentages of FHA Prepayment Experience:			Class A-3 Bonds at the following percentages of FHA Prepayment Experience:		
	0%	100%	200%	0%	100%	200%	0%	100%	200%
Initial Balance	100%	100%	100%	100%	100%	100%	100%	100%	100%
August 1, 1984	97	91	85	100	100	100	100	100	100
August 1, 1985	93	74	53	100	100	100	100	100	100
August 1, 1986	88	51	14	100	100	100	100	100	100
August 1, 1987	83	27	0	100	100	87	100	100	100
August 1, 1988	77	1	0	100	100	68	100	100	100
August 1, 1989	68	0	0	100	86	48	100	100	100
August 1, 1990	59	0	0	100	72	31	100	100	100
August 1, 1991	48	0	0	100	59	14	100	100	100
August 1, 1992	36	0	0	100	46	0	100	100	99
August 1, 1993	23	0	0	100	33	0	100	100	52
August 1, 1994	8	0	0	100	20	0	100	100	7
August 1, 1995	0	0	0	96	8	0	100	100	0
August 1, 1996	0	0	0	86	0	0	100	83	0
August 1, 1997	0	0	0	75	0	0	100	37	0
August 1, 1998	0	0	0	63	0	0	100	0	0
August 1, 1999	0	0	0	49	0	0	100	0	0
August 1, 2000	0	0	0	34	0	0	100	0	0
August 1, 2001	0	0	0	16	0	0	100	0	0
August 1, 2002	0	0	0	0	0	0	87	0	0
August 1, 2003	0	0	0	0	0	0	8	0	0
August 1, 2004	0	0	0	0	0	0	0	0	0
August 1, 2005	0	0	0	0	0	0	0	0	0
August 1, 2006	0	0	0	0	0	0	0	0	0
August 1, 2007	0	0	0	0	0	0	0	0	0
August 1, 2008	0	0	0	0	0	0	0	0	0
August 1, 2009	0	0	0	0	0	0	0	0	0
August 1, 2010	0	0	0	0	0	0	0	0	0
August 1, 2011	0	0	0	0	0	0	0	0	0
August 1, 2012	0	0	0	0	0	0	0	0	0
August 1, 2013	0	0	0	0	0	0	0	0	0
Average Weighted Life (years) :	7.55	3.20	2.25	15.96	8.98	6.25	19.72	13.97	10.31

CHART 3

FIRST "Z-CLASS" CMO -- September 1983

	Percent of Initial Principal Balance Outstanding for:															
	Class B-1 Bonds at the following percentages of FHA Prepayment Experience:				Class B-2 Bonds at the following percentages of FHA Prepayment Experience:				Class B-3 Bonds at the following percentages of FHA Prepayment Experience:				Class B-4 Bonds at the following percentages of FHA Prepayment Experience:			
Payment Date	0%	75%	100%	200%	0%	75%	100%	200%	0%	75%	100%	200%	0%	75%	100%	200%
Initial Balance	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%
October 1, 1984	84	78	76	68	100	100	100	100	100	100	100	100	112	112	112	112
October 1, 1985	66	46	39	9	100	100	100	100	100	100	100	100	126	126	126	126
October 1, 1986	42	6	0	0	100	100	91	32	100	100	100	100	141	141	141	141
October 1, 1987	21	0	0	0	100	56	33	0	100	100	100	83	159	159	159	159
October 1, 1988	0	0	0	0	92	0	0	0	100	79	90	54	178	178	178	178
October 1, 1989	0	0	0	0	55	0	0	0	100	57	67	25	199	199	199	199
October 1, 1990	0	0	0	0	13	0	0	0	100	44	43	0	224	224	224	224
October 1, 1991	0	0	0	0	0	0	0	0	88	20	18	0	252	252	252	217
October 1, 1992	0	0	0	0	0	0	0	0	70	9	0	0	282	282	267	177
October 1, 1993	0	0	0	0	0	0	0	0	50	0	0	0	317	290	263	142
October 1, 1994	0	0	0	0	0	0	0	0	27	0	0	0	356	274	233	112
October 1, 1995	0	0	0	0	0	0	0	0	1	0	0	0	399	246	204	85
October 1, 1996	0	0	0	0	0	0	0	0	0	0	0	0	382	218	176	60
October 1, 1997	0	0	0	0	0	0	0	0	0	0	0	0	357	191	149	38
October 1, 1998	0	0	0	0	0	0	0	0	0	0	0	0	329	164	122	17
October 1, 1999	0	0	0	0	0	0	0	0	0	0	0	0	298	136	95	0
October 1, 2000	0	0	0	0	0	0	0	0	0	0	0	0	263	107	68	0
October 1, 2001	0	0	0	0	0	0	0	0	0	0	0	0	223	77	40	0
October 1, 2002	0	0	0	0	0	0	0	0	0	0	0	0	178	46	11	0
October 1, 2003	0	0	0	0	0	0	0	0	0	0	0	0	128	15	0	0
October 1, 2004	0	0	0	0	0	0	0	0	0	0	0	0	72	0	0	0
October 1, 2005	0	0	0	0	0	0	0	0	0	0	0	0	9	0	0	0
October 1, 2006	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0
Average Weighted Life (years)[1]:	2.9	2.1	1.9	1.5	6.3	4.3	3.9	3.0	10.1	7.5	6.9	5.4	17.3	14.4	13.0	10.3

[1]

[1]Qualifies as "current assets" able to support exempt commercial paper under SEC no-action letters.

EXAMPLE FROM 1991

CHART 4

"PAC" (or "TAC") and "Companion" ("Toxic Waste" or "r") Class CMOs

Percent of Initial Certificate Principal Balance Outstanding at the Following Percentages of SPA

[COMPANION CLASSES]

Distribution Date	Class A-1					Class A-3					Class A-5					Class A-12					Class A-14				
	0%	100%	200%	300%	450%	0%	100%	200%	300%	450%	0%	100%	200%	300%	450%	0%	100%	200%	300%	450%	0%	100%	200%	300%	450%
Initial Percentage	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100
August 25, 1992	99	92	85	85	85	99	93	88	88	88	100	100	100	100	100	100	100	100	100	44	100	100	100	38	0
August 25, 1993	97	77	58	58	34	97	81	65	65	45	100	100	100	100	100	100	100	100	26	0	100	100	100	0	0
August 25, 1994	95	60	27	19	0	96	66	39	32	0	100	100	100	100	81	100	100	100	0	0	100	100	100	0	0
August 25, 1995	93	43	*	0	0	94	52	16	0	0	100	100	100	89	17	100	100	100	0	0	100	100	100	0	0
August 25, 1996	91	28	0	0	0	92	39	0	0	0	100	100	76	44	0	100	100	100	0	0	100	100	100	0	0
August 25, 1997	88	14	0	0	0	90	28	0	0	0	100	100	44	10	0	100	100	100	0	0	100	100	100	0	0
August 25, 1998	86	*	0	0	0	88	17	0	0	0	100	100	17	0	0	100	100	100	0	0	100	100	100	0	0
August 25, 1999	83	0	0	0	0	85	0	0	0	0	100	95	0	0	0	100	100	100	0	0	100	100	100	0	0
August 25, 2000	79	0	0	0	0	83	0	0	0	0	100	77	0	0	0	100	100	100	0	0	100	100	100	0	0
August 25, 2001	76	0	0	0	0	80	0	0	0	0	100	60	0	0	0	100	100	100	0	0	100	100	100	0	0
August 25, 2002	72	0	0	0	0	76	0	0	0	0	100	45	0	0	0	100	100	100	0	0	100	100	100	0	0
August 25, 2003	67	0	0	0	0	72	0	0	0	0	100	30	0	0	0	100	100	100	0	0	100	100	100	0	0
August 25, 2004	62	0	0	0	0	68	0	0	0	0	100	16	0	0	0	100	100	100	0	0	100	100	100	0	0
August 25, 2005	57	0	0	0	0	64	0	0	0	0	100	2	0	0	0	100	100	100	0	0	100	100	100	0	0
August 25, 2006	50	0	0	0	0	58	0	0	0	0	100	0	0	0	0	100	100	100	0	0	100	100	100	0	0
August 25, 2007	44	0	0	0	0	53	0	0	0	0	100	0	0	0	0	100	100	100	0	0	100	100	100	0	0
August 25, 2008	36	0	0	0	0	46	0	0	0	0	100	0	0	0	0	100	100	100	0	0	100	100	100	0	0
August 25, 2009	28	0	0	0	0	39	0	0	0	0	100	0	0	0	0	100	100	78	0	0	100	100	100	0	0
August 25, 2010	19	0	0	0	0	32	0	0	0	0	100	0	0	0	0	100	100	49	0	0	100	100	100	0	0
August 25, 2011	8	0	0	0	0	23	0	0	0	0	100	0	0	0	0	100	100	24	0	0	100	100	100	0	0
August 25, 2012	0	0	0	0	0	11	0	0	0	0	100	0	0	0	0	100	100	2	0	0	100	100	100	0	0
August 25, 2013	0	0	0	0	0	0	0	0	0	0	89	0	0	0	0	100	100	0	0	0	100	100	83	0	0
August 25, 2014	0	0	0	0	0	0	0	0	0	0	67	0	0	0	0	100	100	0	0	0	100	100	66	0	0
August 25, 2015	0	0	0	0	0	0	0	0	0	0	43	0	0	0	0	100	100	0	0	0	100	100	51	0	0
August 25, 2016	0	0	0	0	0	0	0	0	0	0	16	0	0	0	0	100	100	0	0	0	100	100	39	0	0
August 25, 2017	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	100	57	0	0	0	100	100	28	0	0
August 25, 2018	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	100	11	0	0	0	100	100	18	0	0
August 25, 2019	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	100	0	0	0	0	100	66	10	0	0
August 25, 2020	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	29	0	0	0	0	100	22	3	0	0
August 25, 2021	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0
Weighted Average Life in Years	13.81	3.68	2.26	2.14	1.70	15.00	4.28	2.57	2.39	1.86	23.68	10.78	5.92	4.97	3.51	28.95	26.19	19.08	1.84	1.00	29.34	28.39	24.50	0.85	0.45

[1] [1]

(*) Indicates a number that is greater than zero but less than .5%.

[1]High volatility of repayment would likely justify an "r" rating from S&P.

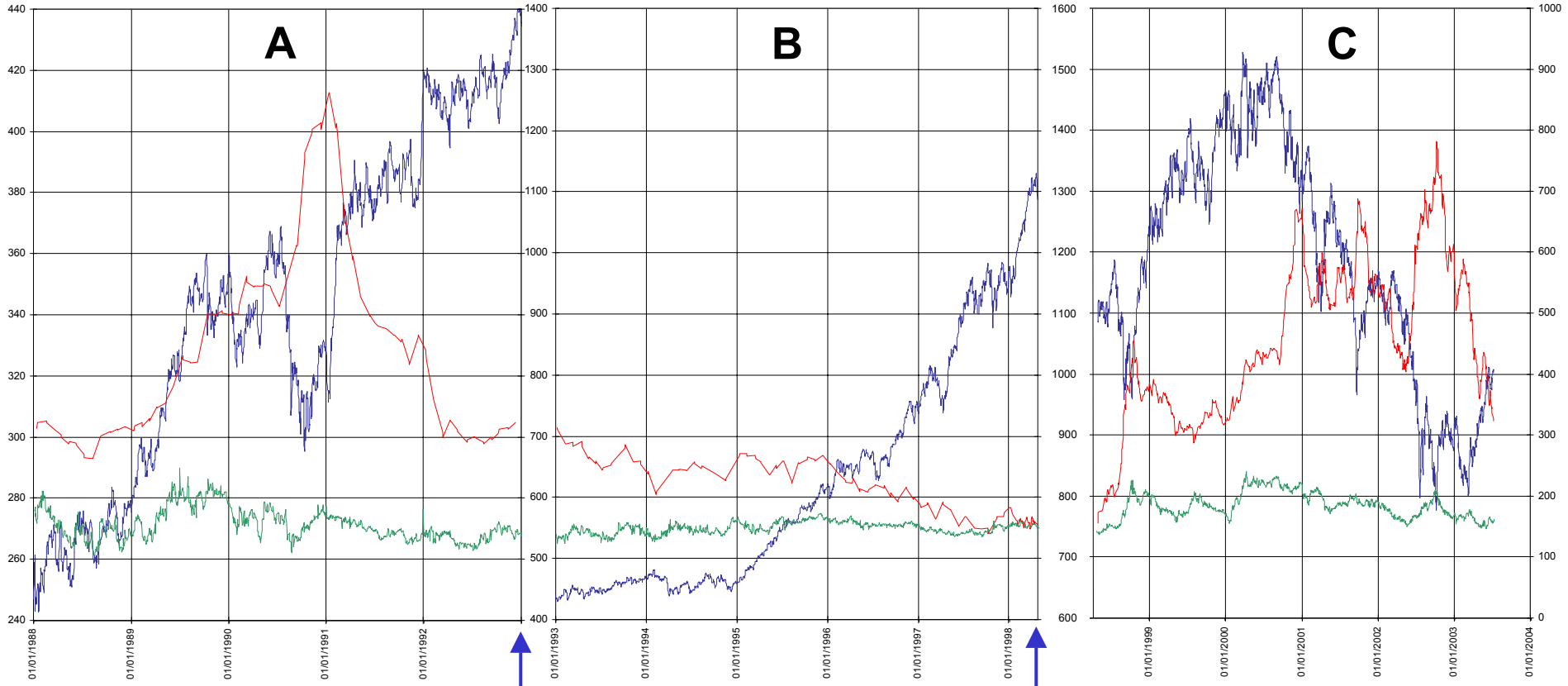
PERFORMANCE OF EQUITIES IN RELATION TO MORTGAGE AND CORPORATE SPREADS (1988-Present)

CHART 5

RED: High Yield Bonds minus AA-rated 10+ Year Bonds (in Basis Points--Source: The Wall Street Journal)

GREEN: LEHMTG Index minus 10-Yr. Treasurys (in Basis Points--Source: Lehman Bros.)

BLUE: S&P 500 Index



January 1988 - December 1992

Rule 3a-7 enacted

January 1993 - April 27, 1998

"10% obligor" restriction takes hold

April 27, 1998 - July 9, 2003

FIRST SHELF REGISTERED NON-MORTGAGE CMO — CHART 6
December 1992

Percent of Initial Principal Balance or Initial Certificate Balance at Various ABS Percentages

Payment Date	Class A-1 Notes				Class A-2 Notes				Class A-3 Notes				Certificates			
	0.5%	1.0%	1.3%	1.6%	0.5%	1.0%	1.3%	1.6%	0.5%	1.0%	1.3%	1.6%	0.5%	1.0%	1.3%	1.6%
Closing Date	100.000	100.000	100.000	100.000	100.000	100.000	100.000	100.000	100.000	100.000	100.000	100.000	100.000	100.000	100.000	100.000
March 1993	73.872	68.893	64.867	59.355	100.000	100.000	100.000	100.000	100.000	100.000	100.000	100.000	100.000	100.000	100.000	100.000
June 1993	47.883	39.064	31.992	22.403	100.000	100.000	100.000	100.000	100.000	100.000	100.000	100.000	100.000	100.000	100.000	100.000
September 1993	22.051	10.578	1.488	0.000	100.000	100.000	100.000	89.440	100.000	100.000	100.000	100.000	100.000	100.000	100.000	95.631
December 1993	0.000	0.000	0.000	0.000	96.430	83.685	73.759	60.735	100.000	100.000	100.000	100.000	98.523	93.250	89.144	83.756
March 1994	0.000	0.000	0.000	0.000	71.235	58.379	48.627	36.238	100.000	100.000	100.000	100.000	88.100	82.781	78.747	73.621
June 1994	0.000	0.000	0.000	0.000	49.428	37.164	28.133	17.081	100.000	100.000	100.000	100.000	79.078	74.004	70.268	65.696
September 1994	0.000	0.000	0.000	0.000	30.134	18.998	10.999	1.462	100.000	100.000	100.000	100.000	71.096	66.488	63.179	59.234
December 1994	0.000	0.000	0.000	0.000	11.976	2.731	0.000	0.000	100.000	100.000	90.686	72.092	63.583	59.759	57.118	54.101
March 1995	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	94.432	75.319	62.576	48.550	57.726	54.625	52.558	50.282
June 1995	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	66.309	51.297	41.639	31.391	53.163	50.728	49.161	47.499
September 1995	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	49.077	36.365	28.295	19.839	50.368	48.306	46.996	45.625
December 1995	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	35.263	24.671	18.021	11.123	48.127	46.408	45.330	44.211
March 1996	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	22.314	14.225	9.220	4.096	46.026	44.714	43.902	43.071
June 1996	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	12.936	6.766	2.972	0.000	44.505	43.504	42.888	38.265
September 1996	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	6.200	1.515	0.000	0.000	43.412	42.652	36.076	22.470
December 1996	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	40.349	26.948	18.707	10.310
March 1997	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	10.008	6.403	4.187	1.928
June 1997	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000
September 1997	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000
December 1997	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000
Weighted Average Life (years)	0.60	0.54	0.49	0.45	1.64	1.50	1.40	1.26	2.96	2.77	2.63	2.46	2.89	2.77	2.66	2.50

[1] [1] [1] [1]

[1]Qualify as "current assets" able to support exempt commercial paper under SEC no-action letters.

FIRST NON-MORTAGE CMO
WITH MONEY MARKET FUND "BULLETS" -- February 1993

CHART 7

Percent of Initial Principal Balance or
Initial Certificate Balance at Various ABS Percentages

Payment Date	Class A-1 Notes				Class A-2 Notes				Class A-3 Notes				Class A-4 Notes			
	0.5%	1.3%	1.5%	1.7%	0.5%	1.3%	1.5%	1.7%	0.5%	1.3%	1.5%	1.7%	0.5%	1.3%	1.5%	1.7%
Closing Date	100.000	100.000	100.000	100.000	100.000	100.000	100.000	100.000	100.000	100.000	100.000	100.000	100.000	100.000	100.000	100.000
May 1993	0.000	0.000	0.000	0.000	100.000	100.000	100.000	100.000	100.000	100.000	100.000	100.000	92.243	67.263	59.040	49.446
August 1993	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	100.000	100.000	100.000	100.000	83.296	44.155	31.463	16.806
November 1993	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	53.740	4.550	0.000	0.000
February 1994	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000
May 1994	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000
August 1994	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000
November 1994	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000
February 1995	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000
May 1995	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000
August 1995	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000
November 1995	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000
February 1996	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000
May 1996	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000
August 1996	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000
November 1996	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000
February 1997	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000
May 1997	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000
August 1997	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000
November 1997	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000
February 1998	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000
Weighted Average Life (years)	0.26 [1]	0.26 [1]	0.26 [1]	0.26 [1]	0.51 [1]	0.51 [1]	0.51 [1]	0.51 [1]	0.76 [1]	0.76 [1]	0.76 [1]	0.76 [1]	0.83	0.55	0.49	0.43 [2]

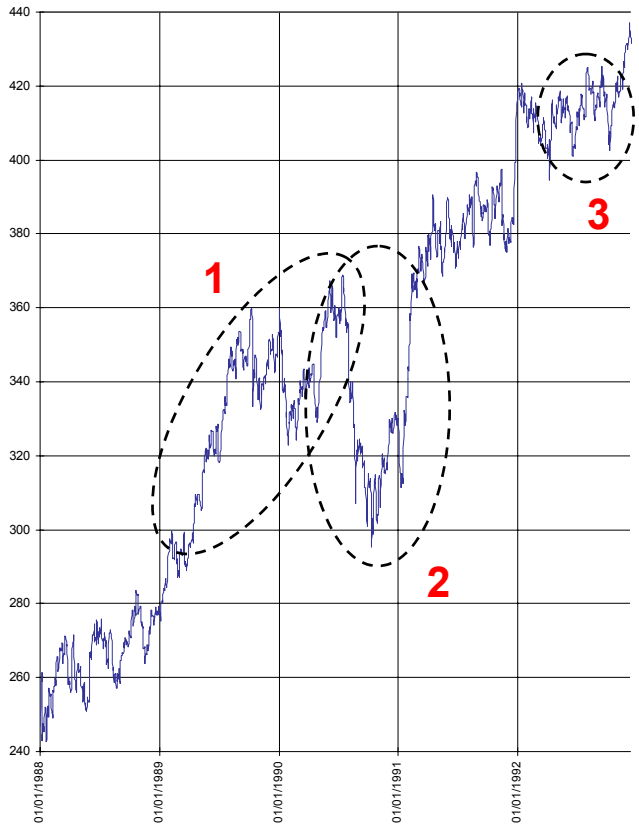
Payment Date	Class A-5 Notes				Class A-6 Notes				Class A-7 Notes				Certificates			
	0.5%	1.3%	1.5%	1.7%	0.5%	1.3%	1.5%	1.7%	0.5%	1.3%	1.5%	1.7%	0.5%	1.3%	1.5%	1.7%
Closing Date	100.000	100.000	100.000	100.000	100.000	100.000	100.000	100.000	100.000	100.000	100.000	100.000	100.000	100.000	100.000	100.000
May 1993	100.000	100.000	100.000	100.000	100.000	100.000	100.000	100.000	100.000	100.000	100.000	100.000	100.000	100.000	100.000	100.000
August 1993	100.000	100.000	100.000	100.000	100.000	100.000	100.000	100.000	100.000	100.000	100.000	100.000	100.000	100.000	100.000	100.000
November 1993	100.000	100.000	95.542	88.384	100.000	100.000	100.000	100.000	100.000	100.000	100.000	100.000	100.000	100.000	98.180	95.257
February 1994	99.348	77.251	70.421	62.803	100.000	100.000	100.000	100.000	100.000	100.000	100.000	100.000	99.734	90.711	87.922	84.812
May 1994	81.264	57.256	49.896	41.720	100.000	100.000	100.000	100.000	100.000	100.000	100.000	100.000	92.349	82.546	79.541	76.203
August 1994	63.290	38.683	31.222	22.982	100.000	100.000	100.000	100.000	100.000	100.000	100.000	100.000	85.010	74.963	71.916	68.552
November 1994	45.440	21.601	14.488	6.701	100.000	100.000	100.000	100.000	100.000	100.000	100.000	100.000	77.721	67.988	65.083	61.903
February 1995	27.725	6.083	0.000	0.000	100.000	100.000	99.235	74.720	100.000	100.000	100.000	100.000	70.488	61.651	59.081	56.305
May 1995	12.883	0.000	0.000	0.000	100.000	76.905	57.132	36.060	100.000	100.000	100.000	100.000	64.428	56.553	54.314	51.929
August 1995	0.000	0.000	0.000	0.000	98.335	38.961	22.516	5.268	100.000	100.000	100.000	100.000	58.979	52.257	50.395	48.443
November 1995	0.000	0.000	0.000	0.000	58.923	8.940	0.000	0.000	100.000	100.000	92.449	69.519	54.517	48.859	47.320	45.720
February 1996	0.000	0.000	0.000	0.000	30.031	0.000	0.000	0.000	100.000	79.320	60.626	41.280	51.246	46.404	45.099	43.749
May 1996	0.000	0.000	0.000	0.000	1.450	0.000	0.000	0.000	100.000	48.271	33.962	19.284	48.011	44.237	43.239	42.214
August 1996	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	61.541	23.316	13.447	3.449	45.163	42.496	41.807	41.110
November 1996	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	40.053	9.341	1.421	0.000	43.664	41.521	40.968	0.000
February 1997	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	23.226	0.000	0.000	0.000	42.490	0.000	0.000	0.000
May 1997	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	6.626	0.000	0.000	0.000	41.331	0.000	0.000	0.000
August 1997	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000
November 1997	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000
February 1998	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000
Weighted Average Life (years)	1.84	1.51	1.42	1.32 [2]	2.98	2.57	2.46	2.30 [2]	3.84	3.41	3.27	3.09 [2]	3.14	2.74	2.66	2.50 [2]

[1] No variance in maturity, qualifying for direct investment by money market funds.

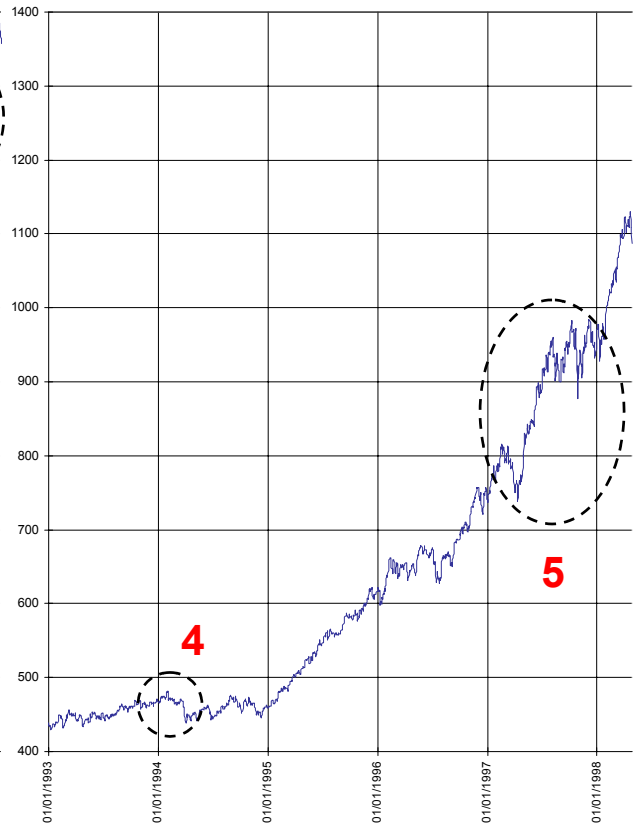
[2] Qualify as "current assets" able to support exempt commercial paper under SEC no-action letters.

CHART 8

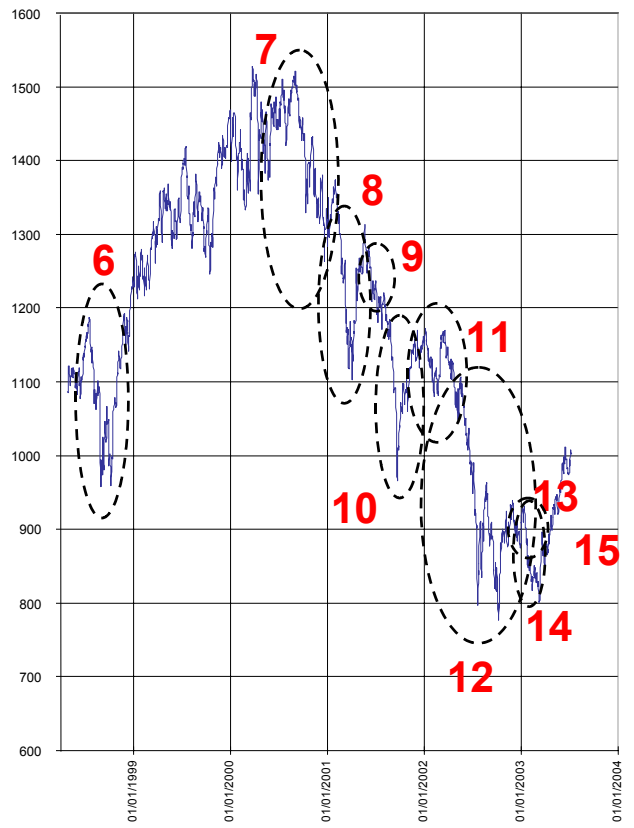
S&P 500 INDEX



January 1988 -
December 1992



January 1993 -
April 27, 1998



April 27, 1998 -
July 9, 2003

FOLEY LARDNER
ATTORNEYS AT LAW

The "Suicide" Monopoly

By: Frederick L. Feldkamp

"Monopoly" is a Depression-era board game based on real estate development. The winner gains a monopolist's pricing power.

The supply of real estate cannot be increased during the course of the game. Reflecting times when the game was invented, the winner's control of property and pricing soon drives all other players (the customers for his or her hotels, railroads and utilities) into bankruptcy.

Monopolizing the market for commodities with substitutes is much more difficult than cornering real estate in particular locations. It is hard to control the supply of fungible commodities and the development of substitutes. Cornering a commodity is a goal that has often been sought, but rarely successfully.

Any effort to monopolize a monetary "commodity," like commercial credit, seems economically inconceivable. Success, moreover, seems suicidal.

To control credit, government complicity is essential. Otherwise the supply of money to fund substitutes is unlimited. Government complicity, however, is notoriously fickle. Governments have a nasty habit of abandoning monopolists when they most need help. Dictators tend to be "for sale" to the next high bidder. Democratic governments tend to abandon monopolists when voters get hurt and let their voices be heard.

Moreover, the use of pricing power in credit markets directly harms a monopolist. Exercising power to raise the cost of credit above the price appropriate for a particular borrower creates a compounding competitive detriment for commercial loan customers. Those customers are the only sources to which the monopolist may look for the payment of its assets.

Yet, through more than a decade of blunder and connivance, the U.S. created rules that, by 1998, gave a group of lenders the ability to use off-balance sheet "straw-man" nominees in a way that gained rather effective control of U.S. short-term corporate credit markets. With: (1) laws and rules that created unique access to various key funding sources and made it hard for potential competitors to similarly access the same sources, (2) no requirement to report activities to shareholders (who might object to this form of speculation) and (3) very low capital requirements based on accounting rules that kept the nominees off-balance sheet, these lenders soon dominated the U.S. market for short-term corporate loans.

While all net benefits and risks of the nominees that made the loans fell on their sponsors' shoulders, rules of bank regulators, the SEC and FASB treated each nominee as a separate entity. With little or no required capital, the sponsors' assured funding access through government liquidity support (insured deposits and discount window access) created a moral hazard risk that could not be contained forever. Enron's demise brought those risks to light.

Once control was gained, the price of credit (measured by spreads) soon began to rise.

Between April 1998 and October 2002, spreads between high grade and high yield corporate debt widened by over 600 basis points, more than offsetting the benefits of government efforts to reduce interest rates. Stock values dropped $3.4 trillion during the same period, as rising spreads devoured corporate cash flows and income.

As the relative cost of debt rose, loan losses also rose, ultimately to record levels. As 2002 ended, *The American Banker* reported major banks were yet again shifting losses on bad loans to their performing loan customers, in the form of higher charges:

"Smarting from record loan losses, the nation's top-ranked syndicated lenders . . . have toughened terms and raised fees on corporate loans." December 27, 2002, p. 20.

Participating lenders had, in effect, become their own worst enemies. They were systematically pushing their customers into bankruptcy. How could corporate customers let that trend continue? CUSTOMERS HAVE SHAREHOLDERS TOO!

When lenders make bad investments, we cannot have a system that shifts losses to customers. It's bad for everyone. To assure correct incentives, loan losses must fall first on the lender's shareholders, then on its creditors. Good customers will, of course, regret losing any lender that "undercharges" for loans, but they will not miss one that seeks to charge them for losses on others' loans.

If customers that perform their loans are made to bear losses of those that don't, we have now seen that a vicious cycle is created where ever rising credit cost spreads create an ever larger group of defaulting borrowers. That's the fundamental mistake that sank Japan, and is still keeping it down. Borrowers, banks, shareholders, depositors and taxpayers all eventually lose by that system.

Until loan losses are recognized and absorbed by lenders' shareholders, they just keep dragging an economy down. When lenders cannot or will not absorb their loan losses, a nation needs to change the practices of its lenders or create new lenders and new systems of non-bank intermediation and capital formation that will deliver funds to its businesses at market-dictated prices.

It appears that the U.S. has now recognized its errors of the past few years and is quickly fixing them. Since October, when it became clear that the FASB would require consolidation of many of the nominees that had been used to create pricing power, credit spreads between high grade and high yield corporate bonds have fallen dramatically. This enormously beneficial process, moreover, accelerated when President Bush proposed to exempt dividends paid to individuals from federal income taxation. Exempting dividends from taxes makes equity capital an effective substitute for debt, reducing lenders' market power.

Everyone benefits from these moves, if they are allowed to work.

How large are the potential benefits of free market pricing?

Between October 9, 2002 and January 9, 2003, the spread between high grade and high yield (unrated) corporate bonds (as reported in *The Wall Street Journal*) narrowed by roughly 275 basis points. With about $3 trillion of outstanding unrated corporate debt, that produces a potential aggregate annual interest savings of $82.5 billion. Applying a price/earnings ratio of 20 to that savings, that re-creates $1.65 trillion of implicit shareholder value which had been lost to rising spreads. That will certainly reduce loan losses and fund any equity lenders may require to consolidate their straw-man nominees.

After years of struggle, therefore, it seems clear that the U.S. now "gets it" and is rapidly heading in the direction of winning this economic "war." If participants in this process somehow "dodge" the President's and FASB's initial "bullets," moreover, a U.S. Senate subcommittee recently issued a very strong bipartisan report making it clear that regulators (and, if necessary, Congress) will be waiting in the wings with "howitzers" of their own.

As always, there is danger that reform efforts will "slip," or go too far and cut off the capacity of participants to do "true" securitizations. An IASB proposal to ban securitizations with "continuing involvement," for example, seems very wrong. In the U.S., however, our current "teams" all seem to well-understand the difference between true and false, at least when securitization is the subject.

Thank you, President Bush, Senators and FASB.

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MAGIC MARKETS

If one compares October 2002 to 1998 and January-March 2004, the following observations arise—

OVERVIEW

Worldwide wealth, financial stability and security can be facilitated through markets that lay beyond the traditional model for central/commercial banking.

Systems which permit free and open trading of debt pools, which match the asset and liability diversification of portfolio lending:

(a) eliminate the "tax" burdens which liquidity crises and traditional banking resolutions impose on systemic flexibility and productivity;

(b) align greed with trading processes that stabilize financial markets;

(c) facilitate redeployment of worldwide resources to the highest productivity levels while minimizing loss to those left behind; and

(d) create instant responses to monetary and fiscal policies that magnify the effectiveness of all forms of government intervention (ultimately reducing, or even eliminating, the need for intervention).

POLICY EXAMPLES

Examples of financial policy "taxation" and the potential savings of sound market policies include (based on U.S. markets):

A. "Taxes" on growth arising from necessary traditional responses to financial system crises.

1. CENTRAL BANK TAX. Instability/illiquidity creates the need for a "carry" tax on growth. To resolve illiquidity and restore lost bank capital, a central bank lowers short-term rates to increase profitability of institutions that buy short-term funds to lend long term.

The result is a widened spread, however, which burdens the capacity for businesses to generate profits and increased productivity by matching long-term borrowings to capital improvements. This restrains growth except among a few already well-capitalized firms that typically do not need (or seek) to borrow for growth.

2. COMMERCIAL BANK TAX. Instability/illiquidity creates a need for higher spreads to compensate for liquidity risk. But that, in turn, creates a self-fulfilling consequence of greater instability and illiquidity, creating a "feedback loop" that taxes growth by increasing funding costs. This process, in fact, can be seen as a <u>cause</u> of many crises, not just an effect. The crisis then creates need for a still higher CENTRAL BANK TAX on growth.

While giving an "appearance" to benefit lenders, higher spreads create burdens for bank customers that ultimately serve only to increase default risk.

This "tax" ultimately benefits nobody and only serves to reduce the potential wealth of any nation that permits its imposition.

3. BANK MONOPOLY TAX. Where rules or economic consequences of a crisis require injection of systemic liquidity through particular favored bank-associated sources (commercial banks and conduits they sponsor), non-bank liquidity sources (*e.g.*, money market funds) are restrained from profits, thereby further restraining central bank activity. This result can frustrate the central bank's role and create a "liquidity trap."

Said another way, money market funds, which must compete with banks for funding sources but can only buy assets from bank sources, cannot survive in very low-rate environments, thereby restraining monetary policy when banks are reluctant to make loans at spreads that businesses can afford to pay.

B. Sound, competitive and transparent markets reverse these trends by permitting traders to create timing and risk arbitrage trades that automatically increase liquidity as these three "TAXES" rise. The result is a lowering of the taxes and of the need for any tax. Using the Fall of 2002 (an example of a crisis in U.S. financial markets) as a base, here are some of the potential benefits from sound market policies:

1. CENTRAL BANK TAX. When liquidity is available and stable, the spread between overnight and long-term funding sources for "risk-free" funds reflects a perceived risk of future inflation. At 2002 inflation rates, this spread might be as low as 2%. Yet, during 2002, this "carry" spread was nearly 4% in U.S. markets.

Potential Savings for Long-term Capital: 200 basis points

2. COMMERCIAL BANK TAX. When a portfolio is national in scope and properly underwritten to a diverse group of commercial enterprises, unsecured loans produce profits for shareholders of borrowers and loss can be limited to fraud. Fraud, moreover, can be overcome as a risk with appropriate security. Over 70 years, for example, one broad-based secured lender actually has a history of <u>positive</u> recoveries on all defaulted loans to date (except for underwriting errors). Spreads between high-grade and high-yield bonds were 7.81% in 2002. With elimination of liquidity crises, 0.8% is probably an adequate spread (it fell 6.5% to 1.3% in 2004 with only an expectation of new liquidity from effective competition).

Potential Savings for High-yield Capital: 700 basis points

3. BANK MONOPOLY TAX. When improved productivity assures reduced costs, deflation may, in fact, be triggered by imposing <u>any</u> cost of funds to risk-free overnight funds. In 2002 and 2003, however, the U.S. central bank found it was constrained from lowering rates below 1% by the inability of money market funds to survive. To preserve the survival of non-bank short-term funds and avoid risk of a liquidity trap, non-bank sources need effective direct access to fund corporate debts by purchasing short-term paper from non-bank associated corporate debt pools.

Potential Reduction of Short-term Base Rates: 100 basis points

Such policies, however, only produce "false" benefits where they are implemented without creation of true and full competition in finance. In Smith's time, the flawed model of the Bank of England exemplified this. Today, we see investments which propose partial solutions, to create investment vehicles that cannot compete with established portfolio lenders due to flaws in their construction which limit their ability to competitively diversify and fund their assets on a fully competitive basis.

C. The aggregate potential value of the benefits described above, properly implemented, when compared to the depressing conditions which existed in U.S. corporate debt markets during October 2002, is, therefore, as much as 1000 basis points. That's a rate decline of up to 10% per annum. Here's how that benefit could translate into market upside.

1. CENTRAL BANK TAX. In the fall of 2002, spreads on U.S. residential mortgages over 10-year Treasuries were about 200 basis points. With long-term rate stability, and free market access, this has been as low as 100 basis points. If the "carry" spread narrows to reflect elimination of aggregate liquidity crises, this spread could fall to 75 basis points. Moreover, 10-year Treasuries might fall 100 basis points. This would reduce consumer mortgage rates 2.25% per annum below those of 2002. Mortgage rates would decline from 5.75% to 3.5%. This represents a potential boost of consumer income equal to $157.5 billion per year. Assuming the same monthly mortgage payment, this would eventually add 30% to the buying power of a mortgage (implying a similar rise in home values).

On the business side of these issues, with about $7 trillion of total corporate bonds, 200 basis points of reduced funding costs would add $140 billion to corporate earnings. That's an increase of $2.8 trillion in investment values, at a 20-1 P/E multiple.

2. COMMERCIAL BANK TAX. Between October 2002 and February 2004, the spread between high-grade and high-yield corporate bonds fell by 650 basis points. If that spread stabilized at 80 basis points to achieve a total of 700 basis points savings, the annual savings on $3 trillion of high-yield debt would be $210 billion. That would add another $4.2 trillion to investment values at a 20-1 P/E multiple.

3. BANK MONOPOLY TAX. Opening competition by unwinding past policy errors of the FRB and SEC would allow money market funds to truly compete with institutional lenders for short-term obligations of corporate borrowers. If, as a result of this action, monetary policy is freed to permit the central bank to reduce short-term rates to 0% (to combat deflation fostered by increasing productivity through accelerating growth), the rate on <u>all</u> debt—corporate, consumer and government—should fall 1% in times of need. That's an aggregate savings of perhaps $250 billion per year, with enough combined impact, when compounded over time, to allow repayment of the U.S. national debt.

CONCLUSION

Using U.S. conditions at the most recent low point (October 9, 2002) and comparing that to trends seen in 1998 (and the results of the recovery attained by January 2004), the benefits described above are, it seems, available with long-term acceptance of competition and reporting reforms. They include repayment of the national debt, a 30% increase in home values (and $157.5 billion of consumer savings to pay for that), and a potential $7 trillion increase in investment values.

Is this realistic? We were headed in that direction in 1998. By implementing sound policies since 2002 we appear headed there again (if we learn the lessons of recent history and avoid creating a new crisis that makes real growth appear, in hindsight, to have been a "bubble"). Roughly 70% of the total benefits have already become available and have begun to work. The rest could be available within a year.

Imagine the further potential if these principles can be applied on a worldwide basis.

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