CHAPTER 1

Introduction

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Initially considered by some as a fad to manipulate the balance sheet, securitization has evolved into a strategically important and sustainable form of structured finance for a wide and growing number of issuers including government entities. The term “securitization” refers to a process whereby receivables, loans or other predictable forms of cash flows are pooled and sold to investors through one or more special purpose vehicles (“SPV”) in the form of debt instruments called asset-backed securities or (asset-backed) commercial paper. The asset-backed security is normally rated to an investment grade level by one or more rating agencies based on the strength of the underlying assets, the amount of credit enhancement, and legal structure.

The origins and technology of asset-backed securitization trace back to the U.S. residential mortgage market. Spawned by the U.S. government’s effort to facilitate home ownership, government agencies began issuing securities backed by residential mortgages in the 1970s. Although commercial mortgage-backed securitization began in the early 1980s, the first asset-backed security and asset-backed commercial paper conduit did not appear until the mid-1980s.¹

The benefits of securitization to the issuer include a competitive (although not necessarily lower) funding cost, access to a diversified and, in many cases, longer term funding source, a more efficient use

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¹ Asset backed commercial paper conduits are special purpose corporations administered by a sponsoring bank or issuer to purchase receivables and other securitizable assets and fund the purchase through the issuance of commercial paper. Multiseller conduits created by banks minimize administrative and set-up costs to their clients by spreading these costs among multiple originators.
of the assets being securitized and, particular to the financial services industry, securitization is a valuable tool to manage regulatory capital and risk. These benefits improve financial flexibility and, in recent years, have led to significant growth in international issues and a proliferation of new asset classes being securitized.

Although international issues have been increasing, the U.S. is by far the dominant market for securitization. A constant flow of large volumes of traditional assets such as auto loans, credit cards, home equity loans, manufactured housing and leases drive the market, supplemented by collateralized loan obligations ("CLOs") collateralized bond obligations ("CBOs"), royalty payments, sports revenues, catastrophe risk, structured settlements, and stranded utility costs. In addition to economies of size, the securitization market in the U.S. has benefited from relatively transparent legal, accounting, and tax systems when compared to most other jurisdictions. Many trusts created in relation to emerging market cross border and future flow securitizations are organized under New York law and, in some jurisdictions where guidelines are not clear, accountants look to Financial Accounting Standards Board Statement No. 125 to determine whether a transaction achieves a true sale. Europe, for example, suffers from a lack of standardization not only in asset classes but also in legal, accounting and tax systems, and the lack of a centralized uniform commercial code to register the asset sale. In addition, because the legal systems in France, Spain and Italy operate under civil codes, specific legislation was required to facilitate securitization. Despite these obstacles, Europe is the largest market for securitization outside the U.S., and the fastest growing globally. Through the mid-1990s European investment bankers consistently looked to the U.S. market to export new asset classes and the latest structural innovations. This is no longer the case, as Europe has become known for a number of innovative one-off transactions which include the securitization of social security payments, television rights, pub loans, and, champagne, tourist and future tax revenues. The recent increase in securitization activity in Asia, spurred by the Japanese market, is due to the additional liquidity and capital relief that issuers require in the aftermath of the Asian financial markets crisis.

Led by Mexico, cross border and future flow securitizations are the dominant form of structured financing for financially strong emerging market issuers. Future export receivables from sales of oil and tequila as well as credit card payments and checks sent from migrant workers in the U.S. to their families in Mexico are among the assets securitized. By directing hard currency cash flows from OECD obligors to offshore collection accounts, these structures allow the emerging market issuer to mitigate sovereign risk and thus achieve
investment grade ratings on the debt issued which provides access to competitive and long term funding in the international capital markets not otherwise available on an unstructured basis.

In any jurisdiction and for any asset class, understanding and addressing the numerous legal issues are key in structuring a successful securitization transaction and obtaining the desired rating. These include the regulatory issues of the issuer/industry, the legal structure of the sale (i.e., true sale or a loan), the requirements necessary for a perfection of security interests, the effects of a bankruptcy of the issuer on the structure and cash flows, contractual restrictions (such as negative pledge covenants), and the tax implications on the SPV and investors.

The first five chapters of this book cover topics generally applicable to most types of securitizations (e.g., bankruptcy issues, securities laws, tax laws, uniform commercial code issues and accounting considerations). The remaining chapters focus on, among other things, the legal and regulatory issues relating to the securitization of specific financial asset types (e.g., commercial mortgage loans, CBO, CLOs, future flows or remittances, credit card receivables, automobile loans, structured settlements, lottery prizes, stranded costs and home equity loans) as well as multi-seller commercial paper conduit securitizations. In future supplements to this book, chapters on Canadian, Mexican and United Kingdom securitizations will be added as securitization becomes more international in focus. This book is designed primarily for those who want to acquire a better understanding of how securitizations work but will also serve as a useful reference for seasoned securitization practitioners.