Fundamentals of Mortgage-Backed Securities and Asset-Backed Securities

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For investors, mortgage and asset-backed securities have many advantages, but for lawyers they present many complexities.

MORTGAGE-BACKED AND ASSET-BACKED SECURITIES are becoming increasingly popular forms of investment. And for good reason, they offer investors comparative security and good yields. But forming these kinds of investments requires a good grasp of the complexities of securities and tax law.

BASIC SECURITIZATION STRUCTURES • First, it is best to understand the basic structures used to issue mortgage-backed securities ("MBS") and asset-backed securities ("ABS"). Unless the context indicates otherwise, "ABS" generally includes "MBS."

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Participation Certificates

Participation certificates evidence contractually established participating ownership interests in identified assets. The documents will include:
- Participation and servicing agreement;
- Custodial agreement—no trustee.

Pass-Through Certificates

Pass-through certificates evidence beneficial ownership interests in assets of a trust—typically using a New York common law trust (a “pass-through trust”) with an independent trustee. The documents will include a pooling and servicing agreement.

Asset-Backed Notes, Collateralized Mortgage Obligations (“CMOs”), Pay-Through Bonds, and Other “Bond” Structures

Asset-backed notes, collateralized mortgage obligations (“CMOs”), pay-through bonds, and other “bond” structures constitute debt obligations of a special purpose entity (“SPE”) secured by assets owned by the entity, with payment terms tied to collections on the assets. Typically an SPE is a Delaware business trust. The documents will include:
- Indenture;
- Servicing agreement;
- Corporate charter or trust agreement to create SPE.

Master trusts are used for credit card receivables and other revolving asset pools—typically the SPE is a New York or Delaware common law trust.

Credit Supports

Credit Supports include:
- Surety bonds (e.g., from the Financial Guarantee Insurance Company (“FGIC”) or Financial Security Assurance (“FSA”))—based on the underlying transaction supported to a “BBB” level;
- Subordination, including tranched subordination involving one or more mezzanine classes (rated “BBB” or better);
- Excess spread (net interest on the assets in excess of the interest rate on the securities), which is used to cover losses and create/maintain overcollateralization;
- Mortgage pool insurance can be used to cover first loss position—note typical carveouts for special hazard, bankruptcy, and fraud losses. Mortgage pool insurance may be used in conjunction with a special hazard insurance policy;
- Reserve funds or cash collateral accounts, including accounts funded upfront or over time out of excess cashflows
- Letters of credit with downgrade draw provisions that will create a cash collateral account if the letter of credit issuer is downgraded.

Issues Relating to the Type of Credit Support

Issues relating to the type of credit support include:
- Event risk (risk of downgrade due to future events or an entity’s credit rating);
- “Separate security” issue (separate SEC registration of a credit support instrument);
- Gaps in coverage—especially with insurance policies—structuring and disclosure issues;
- Disclosure issues (e.g., obligor financial information);
- Reimbursement arrangements between seller or its parent and credit support provider;
- Recourse issues for banks and thrifts as sellers.

BASIC SECURITIES LAW PROVISIONS

Under section 5 of the 1933 Act, unless either the security or the transaction is exempt:
- No offer of a security can be made unless a registration statement has been filed (“red herring” prospectus);
• No sale of a security can be made unless the registration statement is effective; and
• No sale of a security can be confirmed unless accompanied or preceded by a prospectus.

Exempted Securities

Exempted securities under section 3, 15 U.S.C. §77c, include:
• Government-issued or guaranteed securities;
• Federal National Mortgage Association (“FNMA” or “Fannie Mae”) and Federal Home Loan Mortgage (“FHLMC” or “Freddie Mac”) securities;
• Bank-issued or guaranteed securities (full recourse, no SPEs), insurance policies—note “separate security” issues—securities of more recent GSEs such as Farmer Mac are not exempt.

Exempted Transactions

Exempted transactions (section 4, 15 U.S.C. §77d) include:
• Transactions by persons other than an issuer, underwriter, or dealer (e.g., secondary trades after the initial distribution is completed); and
• Transactions by an issuer not involving a public offering. Resales by persons taking from an issuer in a transaction not involving a public offering are also exempt, either (i) as private placements under an analysis based on case law and Regulation D, if sold to sophisticated or “accredited” investors as defined under Rule 501(a), 17 U.S.C. §230.501(a), or (ii) under Rule 144A, 17 C.F.R. §240.144A, if sold to investors meeting the strict definition of qualified institutional buyers (“QIBs”). Section 4(5), 15 U.S.C. §77d, exempts certain non-securitized whole loan sales.

Shelf Registration Statements (Rule 415)

Under Rule 415, 17 C.F.R. §230.415, if a large quantity of securities of a specified type are registered by an issuer under an effective registration statement, separate offerings or “take-downs” may be issued in separate series without SEC review of each supplement. Rule 424(b), 17 C.F.R. §230.424(b), requires the supplement to be filed within two business days of the first use.

For MBS pass-through certificates, the price to the public is generally omitted by treating the offering as a “variable price” offering, even though the underwriter may have determined the price before printing the supplement—a liberal interpretation of Regulation S-K item 501(c), 17 C.F.R. pt. 229, allowed under longstanding practice for MBS shelves. But you should disclose it as a fixed price offering if the transaction is actually sold in that manner.

Form S-3, 17 C.F.R. §239.13, was revised in 1992 to permit its use for “asset-backed securities” or securities primarily serviced by cash-flows from a discrete pool of receivables or other financial assets (including mortgage loans), provided that such securities must be rated in one of the top four rating categories by at least one NRSRO—previously, shelf registrations of mortgage-backed securities rated in the top two rating categories and qualified under SMMEA were made on Form S-11, 17 C.F.R. §239.18.

The SEC imposes additional financial disclosure requirements for credit support and swaps providers, and for borrower concentrations (underlying loans of a single borrower or related borrowers, especially where the loans are cross-collateralized or otherwise linked), under the following thresholds based on a percentage of the transaction:
• 10 percent: a summarized financial disclosure is required;
• 20 percent: full, audited financials are required;
• 45 percent: a co-registrant issue may be raised;
The SEC in comment letters precludes the use of shelf registration for:

- Pools with 20 percent concentrations of 30-day delinquency, or any 90-day delinquency;
- Prefunding accounts of 25 percent; and
- Resecuritizations (of securities of unaffiliated issuers), unless the underlying securities were acquired in bona fide secondary market transactions (with 90-day bright line test).

Non-Shelf Registration Statements

What if securities must be registered under the 1933 Act but don’t qualify for shelf registration under Rule 415, 17 C.F.R. §230.415? The SEC must review and approve each offering separately—creating delay and scheduling uncertainty. But, Rule 430A, 17 C.F.R. §230.430A, allows going effective before pricing, thus allowing underwriters to set pricing with customers, print a final prospectus, and send out confirmations without waiting for SEC to declare pricing amendment effective—provided that final prospectus is submitted to the SEC within five business days of going effective and within two business days of pricing.

Blue Sky and SMMEA

Secondary Mortgage Market Enhancement Act of 1984, Pub. L. No. 98-440, 98 Stat. 1689 (“SMMEA”) securities are exempt from state blue sky laws, and are treated under state laws limiting legal investments for various entities as equivalent to U.S. government obligations. The override period expired on October 3, 1991—some states passed limited overrides. Qualification under SMMEA is important as it enhances liquidity and reduces the need for any blue sky or legal investment survey in connection with a public offering.

SMMEA Securities

Mortgage-related securities as defined under section 3(a)(41) of the Securities Exchange Act of 1934, 15 U.S.C. §78c(a)(41) (“SMMEA securities”) are securities evidencing interests in, or secured by, first lien mortgage loans on a single parcel of residential or mixed residential/commercial real estate (including loans secured by co-operative apartments or manufactured housing) that are originated by a bank, thrift, insurance company or similar supervised institution or by a HUD approved mortgagee, provided that such securities must be rated in one of the top two rating categories by at least one nationally recognized statistical rating agency (“NRSRO”)—as amended, loans secured by commercial properties also qualify for SMMEA securities.

For “retail” offerings of SMMEA securities, it is necessary to register under blue sky statutes in the approximately eight states that overrode SMMEA. Most of these states permit blue sky registration for the entire MBS shelf registration (as opposed to a separate filing for each retail class takedown). Under this approach, the total out-of-pocket blue sky filing fees would be about $9,000.

Non-SMMEA MBS Securities

Publicly offered non-SMMEA MBS securities, including “A” and “BBB” rated classes backed by first liens, and any classes backed by second liens, require exemption in New York under Policy Statement 105. See also “Non-SMMEA Securities” below.

Non-SMMEA Securities

Offerings of ABS that do not fall under SMMEA, which includes:

- All ABS backed by assets other than mortgage loans; and
- Any “A” and “BBB” rated MBS backed by first liens, and any MBS backed by second liens are generally made to institutional investors only, to avoid the delay and expense of blue sky filings.