

# Reporting on Servicing Criteria Under Regulation AB

MBA's Accounting, Tax and Financial Analysis Conference  
November 14, 2006

## Objectives

At conclusion of this discourse, participants should have a basic understanding of the following:

- Background of the new SEC rule – Regulation AB
- Servicer compliance with Regulation AB
- Top implementation and interpretative issues on Item 1122
- Legal Considerations

## Regulation AB Background

The final rules and forms are intended to accomplish the following:

- Update and clarify the Securities Act registration requirements;
- Consolidate existing positions that allow modified and more relevant reporting;
- Provide disclosure guidance and requirements;
- Streamline existing positions that permit the use of written communications in a registered offering; and,
- Establish a consistent servicing standard.

## Regulation AB Background

Which securitizations are in scope for Regulation AB?

- Only those meeting the definition of “asset-backed security” issued through the SEC registration process (S-1 and S-3).
- Privately issued securitizations are not subject to the regulation.
- However, as a practical element, many ABS servicers will likely subject all assets serviced for others in the scope of Regulation AB assertions.

## Background – Regulation AB

- What types of companies are impacted by Reg AB?
  - Retail Banks
  - Investment Banks
  - Trustee Banks
  - Mortgage Issuers and Servicers
  - Automobile Captives
  - Insurance Companies
  - Equipment Manufactures
  - Credit Card Issuers and Servicers
  - Student Loan Issuers and Servicers
- Most companies in the banking and capital markets sectors will be impacted.

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## Regulation AB Compliance Requirements

Activities that will likely subject a company to compliance criteria in Section 1122 of Regulation AB:

- Collecting principal interest and other payments from obligors
- Paying taxes and insurance from escrowed funds
- Monitoring and accounting for delinquencies
- Executing foreclosure, when necessary
- Temporarily investing funds pending distribution to investors
- Remitting fees and payments to enhancement providers
- Trustees and others providing services
- Allocating and remitting distributions to security holders

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## Regulation AB vs. USAP

What will change?

Servicing criteria in Section 1122:

- Creates additional and more extensive criteria
- Relates to servicing of all ABS, not just Residential Mortgage Backed Securities
- Affects significantly more parties
- Places significant emphasis on servicers' asset management responsibilities
- Requires review and testing of the periodic cash flow calculations and distributions
- Will likely demand a more rigorous testing approach, similar to the 404-like framework for testing controls (however our attestation procedures will be conducted pursuant to the attestation guidance in AT 601)

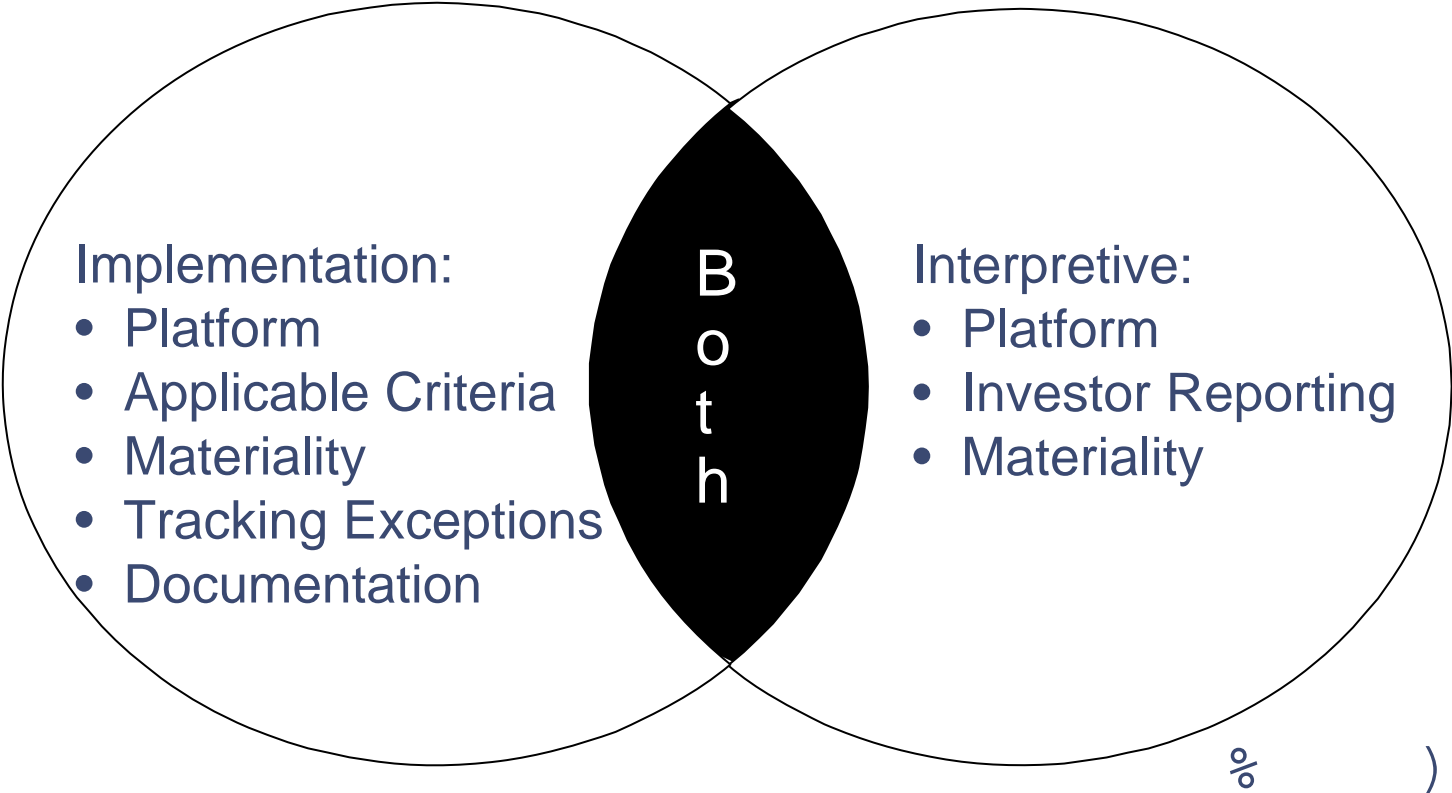
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# Top Implementation or Interpretive Issues

There is intersection between interpretive issues and implementation Issues.



## Has the industry changed views on vendor vs. servicer?

Still being approached as a “control” issue, i.e., which party has effective control of the activity underlying the criteria?

## Vendor Analysis

### Instruction 2 to Item 1122:

“If multiple parties are participating in the servicing function, a separate assessment report and attestation report must be included for each party participating in the servicing function. A party participating in the servicing function means any entity (e.g., master servicer, primary servicers, trustees) that is performing activities that address the criteria in paragraph (d) of this section, unless such entity’s activities relate only to 5% or less of the pool assets.”

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## Vendor Analysis

### Manual of Publicly Available Telephone Interpretations – Reg AB

- 17.03 Pursuant to Rules 13a-18 and 15d-18, an annual report on Form 10-K must include a report from each party participating in the servicing function regarding its assessment of compliance with servicing criteria specified in Item 1122 of Regulation AB, subject to the de minimis exception provided in the notes to the rules.”

## Impact of sales / purchases on Reg AB compliance criteria

- Servicers, with assistance of their internal legal counsel, should evaluate all potential purchases or sales of servicing and/or operations (which are in scope for Reg AB) to determine the impact on on-going compliance requirements subsequent to the transaction close date.
- Servicers should understand the terms of these transactions to adequately plan for any additional compliance requirements which may be introduced as a result of a late (i.e., Q4) purchase or sale.

## Is there more than one definition of a “Servicer”?

### Sec Telephone Interpretation – Section 3. Item 1101 (j) # 3.01

- The definition of a servicer in Regulation AB is a principles-based definition. An entity falls within the definition of servicer if it is responsible for the management or collection of the pool assets or making allocation or distribution to holders, regardless of the entity's title (vendor, trustee, etc.).

- The definition of “Servicer” depends on the specific section reference and use.
- The general use definition of a “Servicer” means any person responsible for the management or collection of pooled assets or making allocations or distributions to holders of ABS.
  - See Section 1108 for Disclosure requirements
  - See Section 1122 for “Parties participating in the servicing function”
  - See Section 1123 for the Servicing Compliance statement

## How are servicers defining their platform?

- Reg AB requires “an assessment of compliance with respect to all asset-backed securities transactions involving the asserting party that are backed by assets of the type backing the asset-backed securities covered by the Form 10-K report.”
- Can management modify the word “all,” so as to define their platform in different ways?
- Industry has proposed several different applications of Platform that may resize the platform. For example, should only “current” deals (pre 1/1/06) be included in the platform?
- This answer will impact the auditor’s testing approach.

- The SEC concluded that the platform may be sized by **EXCLUDING** pre-Reg AB deals (different than 1/1/06 deals)
  - Understand consequence of not all criteria tested in the first year.
  - Transition consistent with disclosure
- The SEC concludes that the platform may **NOT** be sized by excluding de-listed deals.
  - Platforms will generally grow over time
- The SEC said that in general, the platform definition should be consistent year to year.

## May servicers modify the servicing criteria in Item 1122(d)?

### Telephone Interpretation # 11.01

- Servicers may not modify the servicing criteria set forth in Item 1122(d).
- If a Servicer's process differs from one or more criteria in Item 1122(d), the servicer must disclose that it is not in compliance with those particular criteria. The servicer may disclose why the servicer's process is different from the servicing criteria in the report.

## Interpretation #11.02 – Item 1122(d)(3)(i)

- Application of this criterion, as with any Item 1122(d) criterion, depends on the role of the particular servicer. This criterion relates to:
  - Compiling and aggregating activity (i.e., Master Servicing)
  - Timely filing or providing reports
- This may or may not include preparing the underlying calculations (depending on role of servicer). I.e., if Servicer A calculates the waterfall and Servicer B is responsible for compiling the information and reporting to investor, Servicer A would assert to the accuracy of the waterfall, the auditor would assess whether Servicer B appropriately included information from Servicer A and filed the report 10-D timely.

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If Servicer A accumulates and provides information to Servicer B, who is responsible for the accurate aggregation of such information provided to Servicer B?

### Interpretation # 11.03

- The accurate conveyance of the information (i.e., provided by Servicer A) is part of the same servicing criterion under which the activity that generated the information is assessed.
- If the Primary Servicer (i.e., “Servicer A”) is responsible for administering the pool assets and aggregating information about pool assets for reporting to Trustee (i.e., “Servicer B”), and Trustee is responsible for calculating the waterfall or preparing and filing Exchange Act reports with that information, the Master Servicer’s activity's would be assessed under Item 1122(d)(4). Further, this item requires assessment of the Master Servicer’s aggregation and conveyance of such information to the Trustee.

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## What was the recent SEC guidance regarding the investor reports filed with the SEC?

- Criteria Item 1122(d)(3)(i) states: “Reports to investors, including those filed with the Commission, are maintained in accordance with the transaction agreements and applicable Commission requirements....”
- This criteria could be interpreted to require auditors to perform attestation procedures over an issuers compliance with laws and regulations of the Commission for all exchange act reports related to all of the issuing entities covered under the platform.
- Did the SEC intend for this criteria to cover both content and timely filing?
  - No, the SEC said only timely filing, not content or omission (unless specifically required by another criteria) in addition to compiling the information.

## Which investor reports are subject to the criteria?

- “Reports to investors” and the related investor reporting functions have different meanings for different asset classes in the ABS market. Should such reports only include the periodic reports sent to investors (Form 10D) and exchange-act filings (Forms 10K, 8K)?
- “Reports to investors” can also be interpreted to include data or reports for the entire chain of information passing from a servicer, to master servicer, to calculation agent, to trustee. Presumably, each party participating in the servicing function would only assert to the data or reports that they produce.

## Will we need to re-perform the waterfall calculation?

- Criteria item 1122 (d) (3) (i) (b) states “Specifically, such reports provide information calculated in accordance with the terms specified in the transaction agreements.”
- Issue – This criteria implies that management (in making its assertion) and the auditor (in attesting to management’s assertion) will perform procedures to ensure the accuracy of presentation and disclosure of data contained in the investor report (and subsequently filed with Form 10-D). This will likely require some level of re-performance or remodeling of transactions given complexity of cash flow calculations - a significant time investment by management and by attesting auditors.

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## Will some criteria require the opinion of experts?

- Item 1122 (d)(4)(i) states: "Collateral or security on pool assets is maintained as required by the transaction agreements or related pool asset documents."
- Item 1122 (d)(4)(iii) states: "Any additions, removals or substitutions to the asset pool are made, reviewed and approved in accordance with any conditions or requirements in the transaction agreements."

### Telephone Interpretation #11.03

- With regard to Item 1122 (d)(4)(i), an auditor is only required to verify that the mechanics of performing the loan perfection or loan defeasance prescribed in the transaction agreements or related pool asset documents have been performed. )

- The auditor is not required for this or any other criterion to make a legal determination, such as whether the loan perfection and loan defeasance were successfully performed.
- These two criteria could be interpreted to require auditors to assert to the accuracy and adequacy of loan perfection or defeasances. These activities often are conducted under legal requirements and auditors do not have the requisite skills to meet the AT 101.21 adequate knowledge of subject matter requirement, and likely would need the assistance of counsel (as experts) to evaluate compliance.

## Pool Asset Administration Criterion (iv)

- 11.03 In many cases, a servicer will provide information to enable another party (e.g., another servicer) to complete its duties as set forth in the transaction agreements, and the information conveyed is generated by a servicing activity that falls under a particular criterion in Item 1122(d). In that situation, the accurate conveyance of the information is part of the same servicing criterion under which the activity that generated the information is assessed. For example, if Servicer A is responsible for administering the assets of the pool and passing along the aggregated information about the assets in the pool to Servicer B, and Servicer B is responsible for calculating the waterfall or preparing and filing the Exchange Act reports with that information, Servicer A's activity is assessed under Item 1122(d)(4). In addition to assessing Servicer A's maintenance of the records and other activities, this Item requires assessment of Servicer A's aggregation and conveyance of such information to Servicer B.

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## Significant Obligor/Credit Enhancement Provider Reporting

- In lieu of the current Item 1115 requirement requiring fully separated financial statements of a guaranteed subsidiary, the SEC is considering, based on the organization's joint request, only requiring condensed consolidating financial information providing limited financial information as to the subsidiary
- The Staff is not considering any relief for credit enhancers under Item 1114.
- The Staff is not considering easing in any way the requirements under Regulation AB that any such financial statements or selected information be prepared under GAAP.
- The Staff is not considering relief where a derivative is issued by a bank and financial statements or selected information is provided with respect to the holding company, but the holding company does not guarantee the obligations under the derivative.

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# Reporting on Servicing Criteria Under Regulation AB

## The Lawyer's Perspective

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# Party Participating in the Servicing Function “PPSF” Background

- 1122 requires a report and supporting attestation for each “party participating in the servicing function” (PPSF)
- Instruction 2 defines PPSF as any entity (e.g., master servicer, primary servicers, trustee) that is performing activities that address the criteria in 1122(d)
- 1122(d) is a lengthy list, with a number of broad items in it

## PPSF Issues

- When should parties be considered PPSFs, as opposed to mere vendors
  - Issuer/counsel consensus – do not require from vendors whose actions are ministerial
  - Debate on ASF Outside Counsel call
- Status of payment processors (e.g., FDR)
  - Depends on exactly what they do (opening envelopes vs. posting payments)
- Off shore outsourcing

## Contracts and 1122

### Pooling and Servicing Agreement provisions:

- Contractual requirement to provide these reports and related attestations
  - Generally apply even after de-listing, though timing may be more generous
- Contractual servicing standards – generally much more vague than 1122(d)
- Contractual consequences of breaches – general questions:
  - Notice requirements?
  - Servicer termination, loan repurchase or other adverse consequences?
  - Detail in following slides

### Subservicing contracts and agreements with PPSFs

## Contracts and 1122

### Consequences of failing to provide report

- Outside of contract, may affect issuer's ability to file 10-K on time, which can impair the sponsor's access to the market by rendering it ineligible to register in a Form S-3/shelf format
- Within the contract, may trigger a servicer default under "failure to perform" clause
- Likely to become public information, as failure to file will be obvious even if no contractual notice requirement applies

## Contracts and 1122

### Consequences of noncompliance disclosed in the report

- Does not threaten shelf eligibility; SEC decided to keep this within the disclosure-based framework
- Have to be analyzed as possible servicer defaults
  - 1122 standard: material instance of noncompliance with servicing criteria specified in 1122(d)
  - Customary PSA standards:
    - Failure to make a required distribution (notice and grace)
    - Failure to observe other covenants (notice, grace and materiality)
- Notice requirements to be checked

## Contracts and 1122

### Consequences of inaccuracies in the report

- Customary practice for amending periodic reports
- Possibility of securities law liabilities
  - Limit incorporation by reference to limit exposure (phone interp 15.02)

QUESTIONS??????

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