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Speaking of Securitization

The SEC's New Minimum ABS Servicing Criteria and Compliance Reporting Regime

by Marty Rosenblatt

The SEC has released its 495 page Regulation AB (<http://www.sec.gov/rules/final/33-8518.pdf>). Fortunately, only about 30 pages are devoted to Section 1122 on assessments of compliance with the SEC's new minimum servicing criteria for mortgage and asset-backed securities and attestation reports by accounting firms on such assessments. The SEC's uniform servicing criteria which will replace the USAP reporting regime are reproduced in the Appendix to this report.

When?

Existing deals are grandfathered and there is a one-year transition period. Mortgage and asset-backed securities that are the subject of registered offerings commencing after December 31, 2005 must comply with the new rules and forms. If I'm interpreting that correctly, then the first filing of an ABS 10-K under the new rules will not have to be until **March of 2007** for ABS registrants filing on a calendar year basis. (Note to procrastinators: This is not sufficient cause for you to stop reading now.)

There is no requirement that the year-end adopted by the ABS registrant be the same as the year-end of its sponsor. However, I

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would think that the reporting period for the 10-K and the reporting period for the servicing reports should be coterminous, which has not always been the case in the past.

As in the past, a 10-K report is required for the fiscal year in which the takedown off of a registration statement occurs. If, at the beginning of the next fiscal year, the securities of each class in the takedown are held of record (as defined) by less than 300 persons (as defined) no annual or periodic distribution reports need be filed.

What's the Difference Between an Assertion, an Assessment, an Attestation, a Statement and a Certification?

The 10-K must include, among other things:

- (1) **assessments** of compliance with the SEC's minimum servicing criteria from each party participating in the servicing function (Section 1122);
- (2) accountants' **attestation** reports evaluating each servicer's **assertion** regarding compliance with the minimum servicing criteria (Section 1122);
- (3) **statements** from each servicer to the effect that the servicer has fulfilled its obligations under the servicing agreement for the particular transaction (Section 1123); and

- (4) a **certification** by the person signing the 10-K that the 10-K and Form 10-D distribution reports do not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made not misleading, and that all assessments and attestations required to be included have been included, except as otherwise disclosed (Section 302).

Who Must Submit a Servicer's Assessment of Compliance?

The 10-K must include assessments of compliance from each party participating in the servicing function. A party participating in the servicing function means any entity (e.g., master servicer, primary servicers, trustee) that is performing activities that address the minimum servicing criteria unless such entity's activities relate only to 5% or less of the pool assets. The Release does not specify whether the 5% is to be calculated based on principal amount or number of assets nor did it specify whether this was a one-time test at closing or would be applied throughout the year covered by the 10-K. Each party participating in the servicing function will be responsible for having an attestation engagement performed by a registered public accounting firm.

See the last section of the Appendix for the required form of assessment.

Who Must Take Overall Responsibility for Collecting Servicer Assessments?

The person responsible for signing the Sarbanes-Oxley Section 302 Certification must certify that all of the reports on assessment of compliance with servicing criteria and their related attestation reports required to be included in the 10-K have been included as an exhibit to the 10-K, except as otherwise disclosed. Further, any material instances of noncompliance described in such reports must be disclosed in the 10-K.

The certification must be signed either (i) on behalf of the depositor by the senior officer in charge of securitization of the depositor, or (ii) on behalf of the issuing entity (e.g. trust) by the senior officer in charge of the servicing function of the servicer. If a servicer is to sign the report on behalf of the issuing entity and multiple servicers are involved in the servicing of the pool assets, the senior officer in charge of the servicing function of the master servicer (or entity performing the equivalent function) must sign. The trustee is not permitted to sign the report as an alternative to the depositor or the servicer.

Must there be an Assessment for Each Individual Transaction?

Although a separate 10-K must be filed for each trust, the same assessment of compliance with the minimum servicing criteria required by Section 1122 can be filed in each of the 10-Ks. This means that the assessment is to be made on a *platform level* for that asset class (i.e. all transactions involving the asserting party that are backed by assets of the type backing the ABS covered by the particular 10-K). On the other hand, Section 1123 requires a statement of compliance regarding the servicer's obligations under the particular servicing agreement for the ABS transaction rather than the platform level.

For example, if an entity sponsored and serviced four mortgage loan transactions and four auto loan transactions in a given year, there would be a requirement for eight 10-Ks, and eight section 1123 servicer compliance statements and eight section 302 Sarbanes-Oxley certifications but only two section 1122 servicer assessments and only two accountants' attestation reports (i.e., one for the mortgage platform and one for the auto loan platform).

When multiple unaffiliated servicers are involved in a transaction, the math gets more challenging.

There is no requirement for an accountants' attestation report on the Section 1123 servicer compliance statement with the particular servicing agreement for the ABS transaction.

What is Meant by the "Entire Servicing Function"?

The servicing of an asset-backed security consists of many functions, including: collecting principal, interest and other payments from obligors; paying taxes and insurance from escrowed funds; monitoring and accounting for delinquencies; executing foreclosure if necessary; temporarily investing funds pending distribution; remitting fees and payments to enhancement providers, trustees and others providing services; and allocating and remitting distributions to security holders. The minimum servicing criteria are separated into four categories:

- General servicing considerations
- Cash collection and administration
- Investor remittances and reporting
- Pool asset administration

See the Appendix for the detailed criteria.

What if some of the SEC's criteria are not applicable to my activities?

A servicer may exclude a particular criterion either because in its servicing platform it does not participate in that element of the servicing function or the criterion is broadly inapplicable in the context of the asset class being serviced. However, a party may not voluntarily select to exclude specific servicing criteria if they are otherwise applicable to that party. In the event that servicing criteria are excluded for those reasons that are permitted, the inapplicability of the criteria must be disclosed in both the asserting party's assertion and the related registered public accounting firm's report. However, while the individual asserting parties will be permitted to exclude criteria they do not perform, the person making the Section 302 certification must certify whether all required reports covering the entire servicing function, including all the criteria applicable to the asset class, are included with the 10-K.

Are there Penalties for Instances of Noncompliance with the Servicing Criteria? What if Instances of Noncompliance are Subsequently Corrected in the Period?

Disclosure will be required of material instances of noncompliance during the reporting period, even if such noncompliance was subsequently corrected in the period.

A material instance of noncompliance identified in the reports will not by itself have regulatory restrictions on market access, such as an effect on continued Form S-3 eligibility for additional ABS transactions. Rather, the assessment and reporting on the criteria is designed to operate within a disclosure-based framework which the SEC believes will promote investor confidence and market efficiency by decreasing information asymmetries and promoting more efficient pricing and valuation of the securities as well as competition among issuers.

What is an Accountants' Attestation Report?

The accounting firm engaged to perform the examination engagement issues a report expressing its opinion as to whether the servicer's assessment of compliance with the minimum servicing criteria is fairly stated in all material respects, or an opinion to the effect that an overall opinion cannot be expressed and why. The report is prepared in accordance with Statements on Standards for Attestation Engagements No. 10, the Attestation Standards for Compliance Attestation (AT § 601).

The report must be available for general use and not contain restricted use language. The substitution of another type of accountant's report, such as a USAP report or an agreed-upon procedures report will not satisfy the SEC requirement. ABS transactions may continue to require a separate accountant engagement in addition to the report called for by Regulation AB.

Has the SEC considered the additional cost burden of the new 10-K requirements?

Under the Paperwork Reduction Act requirements, the SEC estimated that currently it takes an ABS issuer an average of 90 hours to prepare a 10-K. The most significant difference between the amendments and the existing system is the assessment of compliance with servicing criteria. They estimated that completing and filing a 10-K under the amendments will result in an average increase of approximately 33% over the amount of time currently spent by entities completing the form, or 30 hours per response. It was further estimated that 25% of the reporting burden is borne by the ABS issuer and that 75% of the burden is borne by outside professionals retained by the issuer at an average cost of \$300 per hour.

The SEC's New Standard ABS Servicing Criteria

(1) General servicing considerations.

- (i) Policies and procedures are instituted to monitor any performance or other triggers and events of default in accordance with the transaction agreements.
- (ii) If any material servicing activities are outsourced to third parties, policies and procedures are instituted to monitor the third party's performance and compliance with such servicing activities.
- (iii) Any requirements in the transaction agreements to maintain a back-up servicer for the pool assets are maintained.
- (iv) A fidelity bond and errors and omissions policy is in effect on the party participating in the servicing function throughout the reporting period in the amount of coverage required by and otherwise in accordance with the terms of the transaction agreements.

(2) Cash collection and administration.

- (i) Payments on pool assets are deposited into the appropriate custodial bank accounts and related bank clearing accounts no more than two business days of receipt, or such other number of days specified in the transaction agreements.
- (ii) Disbursements made via wire transfer on behalf of an obligor or to an investor are made only by authorized personnel.
- (iii) Advances of funds or guarantees regarding collections, cash flows or distributions, and any interest or other fees charged for such advances, are made, reviewed and approved as specified in the transaction agreements.
- (iv) The related accounts for the transaction, such as cash reserve accounts or accounts established as a form of overcollateralization, are separately maintained (e.g., with respect to commingling of cash) as set forth in the transaction agreements.

(v) Each custodial account is maintained at a federally insured depository institution as set forth in the transaction agreements. For purposes of this criterion, "federally insured depository institution" with respect to a foreign financial institution means a foreign financial institution that meets the requirements of § 240.13k-1(b)(1) of this chapter.

(vi) Unissued checks are safeguarded so as to prevent unauthorized access.

(vii) Reconciliations are prepared on a monthly basis for all asset-backed securities related bank accounts, including custodial accounts and related bank clearing accounts. These reconciliations:

- (A) Are mathematically accurate;
- (B) Are prepared within 30 calendar days after the bank statement cutoff date, or such other number of days specified in the transaction agreements;

(C) Are reviewed and approved by someone other than the person who prepared the reconciliation; and

(D) Contain explanations for reconciling items. These reconciling items are resolved within 90 calendar days of their original identification, or such other number of days specified in the transaction agreements.

(3) Investor remittances and reporting.

(i) Reports to investors, including those to be filed with the Commission, are maintained in accordance with the transaction agreements and applicable Commission requirements. Specifically, such reports:

- (A) Are prepared in accordance with timeframes and other terms set forth in the transaction agreements;
- (B) Provide information calculated in accordance with the terms specified in the transaction agreements;

(C) Are filed with the Commission as required by its rules and regulations; and

(D) Agree with investors' or the trustee's records as to the total unpaid principal balance and number of pool assets serviced by the servicer.

(ii) Amounts due to investors are allocated and remitted in accordance with timeframes, distribution priority and other terms set forth in the transaction agreements.

(iii) Disbursements made to an investor are posted within two business days to the servicer's investor records, or such other number of days specified in the transaction agreements.

(iv) Amounts remitted to investors per the investor reports agree with cancelled checks, or other form of payment, or custodial bank statements.

(4) Pool asset administration.

(i) Collateral or security on pool assets is maintained as required by the transaction agreements or related pool asset documents.

(ii) Pool assets and related documents are safeguarded as required by the transaction agreements.

(iii) 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.

(iv) Payments on pool assets, including any payoffs, made in accordance with the related pool asset documents are posted to the applicable servicer's obligor records maintained no more than two business days after receipt, or such other number of days specified in the transaction agreements, and allocated to principal, interest or other items (e.g., escrow) in accordance with the related pool asset documents.

- (v) The servicer's records regarding the pool assets agree with the servicer's records with respect to an obligor's unpaid principal balance.
 - (vi) Changes with respect to the terms or status of an obligor's pool asset (e.g., loan modifications or re-agings) are made, reviewed and approved by authorized personnel in accordance with the transaction agreements and related pool asset documents.
 - (vii) Loss mitigation or recovery actions (e.g., forbearance plans, modifications and deeds in lieu of foreclosure, foreclosures and repossessions, as applicable) are initiated, conducted and concluded in accordance with the timeframes or other requirements established by the transaction agreements.
 - (viii) Records documenting collection efforts are maintained during the period a pool asset is delinquent in accordance with the transaction agreements. Such records are maintained on at least a monthly basis, or such other period specified in the transaction agreements, and describe the entity's activities in monitoring delinquent pool assets including, for example, phone calls, letters and payment rescheduling plans in cases where delinquency is deemed temporary (e.g., illness or unemployment).
 - (ix) Adjustments to interest rates or rates of return for pool assets with variable rates are computed based on the related pool asset documents.
 - (x) Regarding any funds held in trust for an obligor (such as escrow accounts):
 - (A) Such funds are analyzed, in accordance with the obligor's pool asset documents, on at least an annual basis, or such other period specified in the transaction agreements;
 - (B) Interest on such funds is paid, or credited, to obligors in accordance with applicable pool asset documents and state laws; and
 - (C) Such funds are returned to the obligor within 30 calendar days of full repayment of the related pool asset, or such other number of days specified in the transaction agreements.
 - (xi) Payments made on behalf of an obligor (such as tax or insurance payments) are made on or before the related penalty or expiration dates, as indicated on the appropriate bills or notices for such payments, provided that such support has been received by the servicer at least 30 calendar days prior to these dates, or such other number of days specified in the transaction agreements.
 - (xii) Any late payment penalties in connection with any payment to be made on behalf of an obligor are paid from the servicer's funds and not charged to the obligor, unless the late payment was due to the obligor's error or omission.
 - (xiii) Disbursements made on behalf of an obligor are posted within two business days to the obligor's records maintained by the servicer, or such other number of days specified in the transaction agreements.
 - (xiv) Delinquencies, charge-offs and uncollectable accounts are recognized and recorded in accordance with the transaction agreements.
 - (xv) Any external enhancement or other support, identified in Item 1114(a)(1) through (3) or Item 1115 of this Regulation AB, is maintained as set forth in the transaction agreements.
- Instructions to Item 1122.**
1. If certain servicing criteria are not applicable to the asserting party based on the activities it performs with respect to asset-backed securities transactions taken as a whole involving such party and that are backed by the same asset type backing the class of asset-backed securities, the inapplicability of the criteria must be disclosed in that asserting party's and the related registered public accounting firm's reports.
 2. 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.
 3. If the asset pool backing the asset-backed securities includes a pool asset representing an interest in or the right to the payments or cash flows of another asset pool and both the issuing entity for the asset-backed securities and the entity issuing the asset to be included in the issuing entity's asset pool were established under the direction of the same sponsor and depositor, see also Item 1100(d)(2) of this Regulation AB.

What is the Required Form of the Assessment?

The assessment must include:

- A statement of the party's responsibility for assessing compliance with the servicing criteria applicable to it.
- A statement that the party used the servicing criteria to assess compliance with the applicable servicing criteria.
- The party's assessment of compliance with the applicable servicing criteria as of and for the period ending the end of the fiscal year covered by the 10-K. The report must include disclosure of any material instance of noncompliance identified by the party.
- A statement that a registered public accounting firm has issued an attestation report on the party's assessment of compliance with the applicable servicing criteria as of and for the period ending the end of the fiscal year covered by the 10-K.

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