

# Reg AB Is Here to Stay:

## *What does this mean for servicers?*

By LaWanda Morris | Tom Knox

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### Background

The Securities Exchange Commission (“SEC”) issued final rules for the Asset Backed Securities (“ABS”) industry on December 22, 2004<sup>1</sup> entitled "Regulation AB", which became effective on January 1, 2006. Regulation AB is a set of newly amended rules and forms to address comprehensively the registration, disclosure and reporting requirements for ABS under the Securities Act of 1933 and the Securities Exchange Act of 1934.

The final rules were intended to accomplish the following:

- Update and clarify the Securities Act registration requirements for ABS offerings, including expanding the types of securities that may be offered in delayed primary offerings on Form S-3;
- Consolidate existing positions, which allow modified Exchange Act reporting that is more relevant to ABS;
- Provide disclosure guidance and requirements for Securities Act and Exchange Act filings involving ABS;
- Streamline existing positions that permit the use of written communications in a registered offering of ABS in addition to the statutory registration statement prospectus; and
- Establish a consistent servicing standard that is used as the basis for measuring each Servicer's performance.

The entire set of requirements is enumerated § 229.1100 through 229.1123. The section of Regulation AB that is of primary importance to Servicers is the annual assertion and accountant's attestation report. These requirements, and the associated servicing standard are described in § 229.1122.

### Where the ABS Industry Has Been

#### *Uniform Single Attestation Program (“USAP”)*

The existing modified reporting system for ABS issuers and servicers did not require audited financial statements for the issuing entity in the annual report on Form 10-K, but has instead generally required an assertion by the servicer and an attestation by an independent public accountant regarding compliance with servicing criteria. This longstanding framework was developed based on the recognition that one of the most important elements affecting an investor's assessment of a particular ABS is the performance of the servicer – and that an independent third party checking some aspect of the servicing function provides a certain level of assurance and transparency regarding the servicer's performance. However, the types of

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<sup>1</sup> Securities Act Release No. 8518 (Dec. 22, 2004) [70 FR 1506] (the “ABS Adopting Release”), available on the Web at <http://sec.gov/rules/final/33-8518fr.pdf>

assessments and attestations, and the criteria that servicing compliance was assessed against, historically have varied significantly. The most common example involves an assertion on and disclosure regarding compliance with criteria set forth in the Uniform Single Attestation Program for Mortgage Bankers, or USAP, developed by the Mortgage Bankers Association of America ("MBA").

The MBA first issued the Uniform Single Attestation Program ("USAP") in 1983, which was subsequently modified in January 1995<sup>2</sup>. The accountant's report attesting to the assertion under the USAP is prepared in accordance with SSAE No. 10 (Statement on Standards for Attestation Engagements issued pre PCAOB). The servicer's assertion as to compliance and the accompanying accountant's attestation report are commonly referred to as a "USAP Report." The servicing criteria enumerated in the USAP program were principally developed for residential mortgage servicing activities. The primary objective was to establish a standard set of servicing criteria for the residential mortgage backed securities industry. This would allow investors, banking institutions and regulators to evaluate Servicers based upon a uniform compliance requirement. Also, by establishing industry standard servicing criteria, residential mortgage servicers would likely be subject to less extensive third party audit requirements.

The ABS industry quickly adopted the USAP servicing criteria as the "industry standard" for many other asset types, such as but not limited to commercial mortgage, auto and credit card asset types. However, given the focus of USAP on residential mortgage ABS transactions, there were numerous criteria that were wholly or partly inapplicable to other asset classes.

The USAP criteria largely focused on cash management and investor reporting aspects of the Servicing process. There were minimal criteria, which evaluated Servicers asset management responsibilities, such as:

- collateral monitoring and surveillance;
- loss mitigation or recovery actions, such as but not limited to loan modifications and restructuring, foreclosures and repossessions;
- administration of pool assets, such as but not limited to asset replacements and loan defeasance; and
- maintenance of credit enhancements.

Further, the USAP did not require the evaluation of periodic reporting required by Servicers to third parties (e.g. reports filed with the SEC for public transactions). As a result, the USAP criteria did not comprehensively cover the full servicing responsibilities associated with ABS transactions. The promulgation of Reg AB was designed to capture some of the gaps present in the application of the historical framework.

## Implementation Challenges

In implementing Reg AB, the ABS industry has been challenged with several implementation issues related to both the disclosure and the attestation requirements. These challenges include:

*Management oversight* – Participants in the ABS market have invested considerable time in amending and updating the required disclosures and the related offering and trust administration documents pursuant to the requirements of Reg AB. Institutions heavily involved both their in house and external legal counsel to understand and interpret the disclosure

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<sup>2</sup> Mortgage Bankers Association of America, Uniform Single Attestation Program for Mortgage Bankers (last rev.1995), Available on the web at [http://store.mortgagebankers.org/ProductDetail.aspx?product\\_code=PB2-110119-BK-P](http://store.mortgagebankers.org/ProductDetail.aspx?product_code=PB2-110119-BK-P)

requirements associated with the securities registration process, changes to periodic reports filed with the SEC and/or investor and disclosure of static pool data. One of the challenges of servicers has been to redirect the focus of their oversight committee to drive compliance with the servicer attestation requirements. This change in focus has also required changes or additions to the existing committee members. Generally, senior executives from the servicing and/or trustee business would be expected to participate in the oversight committee.

Static pool data – The "Sponsor" of the transaction is responsible for making the materiality judgment on the inclusion of static pool data in the disclosure documents. Most CMBS Sponsors have determined that static pool data is not material for their asset type. Sponsors also continue to ask whole loan sellers to provide static pool data upon the sale of a pool. For those sellers that sell all of their loans on a servicing released basis, static pool data is frequently not available. During the first half of 2006, securitization sponsors are continuing to buy these pools of loans, but are dividing the loans into multiple securitization transactions in order to manage the resulting concentration percentage to a minimal level.

Compliance monitoring – Given the increase in servicing compliance requirements, institutions have been challenged with developing a comprehensive monitoring process to track compliance throughout their organization. Compliance monitoring can be a benefit to management to facilitate on going review of their operations and also to allow for early identification of any potential servicing issues.

Disclosure of material non-compliance – Management and the auditor must evaluate and assess all instances of non-compliance and determine which exceptions must be disclosed in management's assertion. The Reg AB guidance does not provide a model for the evaluation of exceptions or examples of material non-compliance. Management will need to use quantitative and qualitative methods of evaluating exceptions when identifying material instances of non-compliance. We expect there to be judgment and skepticism applied when evaluating exceptions. The servicer must be prepared to provide detailed evidence supporting their methodology for assessing exceptions and any related qualitative or quantitative analysis supporting management's conclusions surrounding disclosure of exceptions.

Servicers must also evaluate the legal implications associated with non-compliance with either their transaction agreement or their servicing agreement(s). For example, the Servicer should evaluate if any exceptions might constitute a breach of their servicing contract which may subject the Servicer to certain financial or other penalties.

Responsible party – Servicers continue in their efforts to identify all material parties participating in the servicing process (as defined by Reg AB). This presents a risk in the compliance process since late notification of parties who must comply with the servicer attestation requirements of Reg AB could jeopardize the timely completion of the entity's respective accountant's attestation report.

Material outsourced activities – As required by Item 1122(a) (ii); Servicers must institute policies and procedures to monitor all material servicing activities outsourced to third parties. Management must implement an effective monitoring process to identify vendors servicing a material component of the transaction at the platform level. This process may prove to be difficult and require a transaction level analysis to identify all third parties who participate in the servicing process.

Platform definition – The industry continues to evaluate the appropriate definition of "platform", which is most appropriate for their respective business. The SEC recently provided guidance that allows asserting parties some flexibility in their definition of platform. See the "Recent SEC Guidance" section below.

Pool assets – Servicers must identify all pool assets in scope based upon management’s definition of the platform. Depending upon the servicer’s degree of automation and use of systems, it may be an onerous process to identify all assets that support the platform.

Waterfall testing – Item 1122 (d) (3) (ii) requires that Servicers accurately calculate distributions made to investors. Institutions are focused on developing new transaction level modeling controls or enhancing existing controls to comply with this requirement. In particular, as the calculation of these distributions is based upon the waterfall rules proscribed in the transaction documents, the auditor will generally be required to reperform the waterfall calculation (using appropriate sampling techniques) in order to evaluate the process Servicers are applying in computing payments to investors. This requirement is a significant change from USAP and will require significant attention on both the part of management and the auditor. Accounting firms will likely use structured finance and modeling specialists to perform such testing.

## Recent SEC Guidance

In December 2005 and August 2006, the SEC issued interpretations of Regulation AB and the related rules. The full list of interpretations can be found on the SEC website under the "telephone interpretations" section. The items below represent the new key interpretations that relate to the assertion and attestation reports required by section 1122:

- Defining the Servicer's Platform (How much flexibility does the asserting party have when defining their Platform?)  
*Interpretation 17.04 allows the asserting party to include only those ABS transactions subject to Regulation AB. Interpretation 17.03 allows the asserting party to define their platforms geographically or based on the computer system on which the information is maintained. The SEC said that it was important for the definition of Platform to remain consistent from period to period and that the platform should never be artificially designed and should mirror actual servicing practices of the asserting party.*
- Modification of servicing criteria enumerated in Item 1122 (May the Servicer modify the description of the servicing criteria in their written assertion on compliance?)  
*The SEC clarified the Servicers may not modify the servicing criteria pursuant to Item 1122. Rather, if the Servicer’s process is different than the criteria, this should be disclosed as material non-compliance.*
- Who is responsible for the accuracy and completeness of aggregated pool asset data provided by multiple Servicers or parties?  
*The SEC clarified that the party who prepares the data is responsible for the accuracy and completeness of their information. The party who is the “data aggregator” is responsible for the completeness of the aggregated data based upon the underlying details. This could fall to one or more parties. At a minimum, a Servicer’s assessment of the various criteria under section 1122(d)(4) should include the accurate aggregation and conveyance of such information. See interpretation 11.03 for more detail.*
- Will some criteria require the use of experts?  
*The SEC clarified that the accountants will not be required to make a legal determination, therefore the use of experts will not be required (e.g. perfection of security interest, loan defeasance) See interpretation 11.04 for more detail.*
- Is there any other guidance on materiality?  
*Interpretation 17.05 makes clear that noncompliance with respect to the Item 1122 servicing criteria, materiality is to be assessed at the platform level. By contrast, for purposes of the Item 1123 servicer compliance statement, materiality is to be assessed in relation to the individual transaction for which such compliance statement relates. As a result, it is possible that instances of non-compliance at the transaction level may be*

*considered material for purposes of the 1123 servicer compliance statement, but would not be considered material for purposes of the platform level assertion and attestation under Item 1122.*

## The Road Ahead

It is expected that 2006 may be among the final years of USAP servicer compliance. While Issuers may continue to report under USAP for historical transactions, many expect that investors will increasingly demand the Reg AB servicer compliance report as the "new" industry standard surrounding servicing compliance.

While there is a significant penalty assessed to issuers for non-compliance with the filing and reporting requirements pursuant to Reg AB, there is no direct penalty assessed by the SEC for material instances of non-compliance identified in the Servicer's assertion and the related accountant's attestation report. At this stage, it is unclear how the market will react to compliance exceptions identified in the Servicer's reports. Some market participants believe there may be an up tick in Servicer termination actions, particularly in cases where there are severe compliance matters contained in a Servicer's report on compliance with Item 1122 of Reg AB

Market practices and SEC interpretations relating to the implementation of Reg AB will continue to evolve over the remainder of 2006. The SEC has stated that it intends to review the disclosures in the registration filings and the compliance statements associated with the 10-K filings in more detail during 2006 and 2007. Market participants may not be able to fully determine their compliance with the SEC intentions until the results of these reviews are communicated to the market.

In spite of the many challenges in implementing the new regime, industry participants have risen to the occasion. They have been working hard to prepare for the challenges of Reg AB and while much work remains to be done, constructive dialogue among all parties involved in the process has been instrumental in ensuring the road ahead is clear and can be traveled with confidence.

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