

# Simplification of securitisation\*

Regulation AB: a new era for asset-backed securities –  
are you prepared?





January 1, 2006 marked the beginning of a new era in the disclosure and periodic reporting requirements related to publicly-issued asset-backed securities ('ABS') in the US because of the Securities and Exchange Commission's Regulation AB ('Reg AB') guidance.

Reg AB does not supplant the Securities and Exchange Acts of 1933 and 1934, but rather enhances them to reflect the development, growth and maturation of the traditional mortgage backed security ('MBS') and ABS markets, now collectively referred to as ABS markets. As a result of Reg AB, there are numerous changes to what now can be defined as an ABS, as well as new and enhanced requirements surrounding the composition, registration, disclosure and reporting responsibilities of issuers associated with a public transaction.

Reg AB also addresses one of the most critical components in the success of any issuance – that is, the servicing of the supporting assets and bonds on behalf

of investors. Changes to the disclosures surrounding the servicing function, as well as the new servicing criteria to be applied to servicing activities, are stipulated in sections 1108 and 1122 of Reg AB, respectively.

Compliance with Reg AB is only required for those securities registered with the SEC. Securities issued into the US under a private 144a programme or issued into a non-US environment do not currently have to comply with the Regulation. In the future compliance with Reg AB may become securitisation best practice and Europe along with the rest of the world may adopt similar legislation. As a result all ABS issuers may want to consider the implications and requirements.



## Why is servicing so important?

Following the issuance of an asset-backed security, the servicing of assets is a critical component in maintaining the viability of the issuance. Generally, market and credit risk are clearly explained in the prospectus and are highlighted at issuance.

Many transactions have multiple servicers (that is, master, primary, and sub-servicing relationships) and special servicers (for example: foreclosure, workout or repossession experts). Some of these servicers are private companies or are less experienced in making assessments as to their compliance with the nuances of servicing individual asset classes that are within the ever-expanding ABS market. The SEC intends for the adoption of Reg AB's uniform criteria for servicing and the related cyclical disclosures to provide investors with greater transparency as to the performance of the servicers who are supporting the value of the underlying assets and ensuring the proper application of cash flows to the bond holders.

In the US prior to the issuance of Reg AB, the servicing of the underlying assets was generally reported upon under a framework known as the Mortgage Banker's Association ('MBA') Uniform Single Attestation Program ('USAP'). In Europe and the rest of the world, reporting upon the servicing of SEC registered debt was contained within the annual 20-F return required to be submitted to the SEC by Foreign Private Issuers ('FPI'). The servicing report within the 20-F was based on USAP or the minimum servicing standard included in the Administration Agreement of the individual ABS issue.

Reg AB provides for broader and more formal servicing performance reporting and also expands upon the definition of a servicer. A servicer is now defined as "... any person responsible for the management or collection of the

pool assets or making allocations or distributions to holders of the asset-backed security(ies)." The criteria to be applied and disclosures required for all those entities deemed servicers are extensive and extend beyond the historic perception of servicing activities.

The industry debated this definition and questioned who may qualify as a servicer under the expanded rules. As Reg AB is a principles-based standard, the broad-based application of the definition should be applied. However, diligence should be taken in any application of the term. The MBA, the American Securitization Forum ('ASF') and other industry groups have been instrumental in advancing common industry views on some of these matters and in seeking further guidance where warranted.

### Implications for foreign ABS registrants

- Under Reg AB there is no longer any distinction between domestic and foreign registrations. All ABS issuers are now required to submit an annual form 10-K which amongst other requirements contains reporting on compliance with the servicing criteria of Reg AB.

Foreign registrants are not allowed to continue using the form 20-F submission.

- Reg AB has introduced a whole new reporting regime for foreign ABS registrants.

The requirement to submit a 10-K is ongoing. Under the 20-F regime it was possible, in some circumstances, to suspend the SEC reporting requirement. Audited financial statements for the issuing entity are not required to be included within the 10-K. Issuers and servicers need to be aware of the ongoing compliance costs of Reg AB.



## Servicer disclosures: section 1108

The disclosures that are a part of Section 1108 are designed to provide insight into what a “... reasonable investor would find material in considering an investment in the asset-backed securities and the servicing and administration of the pool assets and the ABS.”

The three broad areas that need to be addressed are as follows:

1. **Identifying information and experience:** A narrative on the qualifications and expertise of the servicer in performing their functions as they relate to the pool of assets as well as any material financial information or changes to servicing policies and procedures that may affect the pool being serviced.
2. **Servicing agreements and servicing practices:** A description of the terms of the servicing agreement, general and unique elements to servicing a particular asset class, and any limitations on servicer liability.

3. **Back-up servicing:** The naming of an identified back-up servicer as well as a description of the material terms necessary and process in place to bring in a back-up servicer, if needed.

The clear identification of all roles and responsibilities of all material servicers (as defined above) will provide further disclosure to investors as to the level of competence of the parties involved in daily maintenance and monitoring of pool assets, as well as their expertise in the administration of cash allocations and distributions. These disclosures now allow investors to evaluate the manner in which the underlying assets and cash administrative processes are being governed and to make an informed investment decision about a significant component of the process that was formally never disclosed.

## Servicing criteria: section 1122

There are more than 30 specific servicing criteria mentioned in section 1122 of Reg AB, which will become the de facto minimum servicing criteria for all ABS. These criteria are likely to replace the MBA's USAP servicing criteria that have been the residential mortgage industry standard in the US and the requirement of the transaction documents in the rest of the world, as Reg AB criteria are much more extensive but were often applied by analogy to other asset types within the greater ABS market. As no official minimum servicing standard existed for other asset classes, Reg AB marries the newly defined role of servicer (above) with servicing criteria that can be applied across a broader class of assets in the marketplace. Whilst Reg AB is only applicable to public offerings, investors and underwriters may begin to request compliance with Reg AB on private issues. The MBA have drafted a letter which advises members that reporting under section 1122 should satisfy the requirements of USAP. It is expected that the use of USAP will be discontinued over the next few years.

Following are the four general categories of servicing criteria with brief summaries of content:

1. General servicing considerations: Review of the monitoring of trigger events, a third party's performance and compliance of servicing, preparedness for backup servicing, and assurance that the fidelity bond and errors and omissions policies are in effect.
2. Cash collection and administration: A focus on establishing and maintaining proper controls around all forms of cash that may relate to a transaction— inflows, disbursements, and reserve amounts—are all covered as well as the application of cash to obligor's accounts and the subsequent timely reconciliation of the cash accounts.
3. Investor remittance and reporting: Assurance that all requisite investor filings with the SEC have been verified, are accurate, and are in accordance with the underlying transaction agreements.

4. Pool asset administration: Detailed descriptions of daily servicing activities (for example: substitutions of assets, loan modifications, interest rate adjustments, etc.) that are conducted in accordance with the transaction documents and that credit enhancement is properly maintained.

Each of the parties that are defined as servicers must now formally assess and make an assertion regarding their compliance with the criteria 1-4 above. On an annual basis, public accountants will be required to perform an attestation of the servicing party's assertion on compliance with the criteria and note any areas of material non-compliance that have occurred throughout the year, regardless of whether the issue has been remediated by year-end. The ramifications of any material instance of noncompliance include clearly disclosing these elements in the 10-K and while there is no defined penalty for a material instance of non-compliance, the existence of them could affect an issuer's ability to issue securities via their shelf registration. What reaction will the market have? Market participants must be diligent in their preparation for the implementation of these new rules that took effect on January 1, 2006.

Clearly, Reg AB expands upon the existing servicer assertion criteria pursuant to USAP guidance. The new criteria will likely require participants to enhance existing processes and related documentation in order to demonstrate compliance with new servicer criteria. Furthermore, new and expanded disclosure criteria for both initial registration and ongoing monthly reporting under Form 10-D will require automated collection of tremendous amounts of data which will place significant demands on data management, technology, and reporting resources.

Many questions are related to the interpretation of the new rule, which continue to be vetted and clarified by industry participants, attorneys and the accounting firms.

## Industry insights

- Definition of Platform: How should servicers define their servicing platforms? Can a platform be defined to include collateral only for post 1/1/06 deals? Should collateral for registered and non-registered ABS (public and private deals) be included in the platform for similar asset type? Should a platform break out collateral by servicing location, legal entity, collateral type? May servicers exclude deals from compliance testing after a transaction is delisted?
- Identification of “servicer:” What parties participating in the servicing function should be required to issue separate 1122 Servicer Attestation reports? How should companies differentiate between “vendor” versus “servicer?”
- Management documentation of its internal assessment process and testing performed to support its compliance assertion: As the auditor is required under generally accepted auditing standards to ensure that management has a basis for their assessment of compliance, what level of documentation should management maintain to evidence their internal assessment for making their compliance assertions?
- Compliance criteria interpretations: How does the SEC define “all reports to investors” pursuant to section 1122. d.3 (i)? What degree of transaction remodeling by management or the auditors will be required to assert to the accuracy surrounding the calculation of payments remitted to investors?
- Material instances of non-compliance: How will “material instances” of non-compliance be defined for purposes of identifying reportable findings? Should a framework be developed for evaluating “material” exceptions similar to Sarbanes-Oxley assessments conducted under Section 404?
- How should US terminology and practices be interpreted in the control of International issuance?

These issues and others continue to be discussed among industry participants as implementation of the new requirements begins to take hold.

The Securities and Exchange Commission (SEC) issued an online list of frequently asked questions and answers (Q&A) regarding the Securities Offering Reform (SOR).

## Compliance considerations

Whilst the majority of US issuers have reported for the first time under Reg AB this is still an emerging issue for ABS issuers in the rest of the world.

An important distinction of the assessment under Reg AB is a “during the year” assessment, not a “point in time” or “end of year” assessment as many are accustomed to under Sarbanes-Oxley requirements. Management should now be evaluating the suitability of their current processes to meet the new compliance criteria pursuant to Section 1122 of the Regulation.

The MBA, ASF and other bodies have been actively involved in leading industry discussions amongst market participants and major accounting firms to discuss disclosure and servicing criteria related issues with respect to Reg AB.

Over the past year the SEC Division of Corporate Finance has also posted telephone interpretations on the SEC’s web site related to the Regulation. The latest interpretation 17.06 deals with the controversial issue of the distinction between a service and a vendor, which has been a major discussion point during this year.

The questions and answers represent the views of the staff of the Division of Corporation Finance with respect to questions they have received regarding the new rules and forms adopted by the SEC in the SOR rulemaking. The questions and answers are not rules, regulations, or statements of the Commission. Further, the Commission has neither approved nor disapproved the questions and answers.

For those who have already reported under the new regulation, the challenges will continue as services ensure compliance in future years and undertake remediation of material instances of non compliance identified in prior periods.

If not already initiated, management should reach out to legal counsel and their external auditors as quickly as possible to begin discussions surrounding their:

- Servicing compliance assertion: how management will define servicing platform and demonstrate compliance with servicing criteria; and
- Compliance assessment with Reg AB: documentation of management’s assessment, identification of exceptions at transaction level, testing to be performed by management, and the auditors, etc.

## Reflections, thoughts & comments

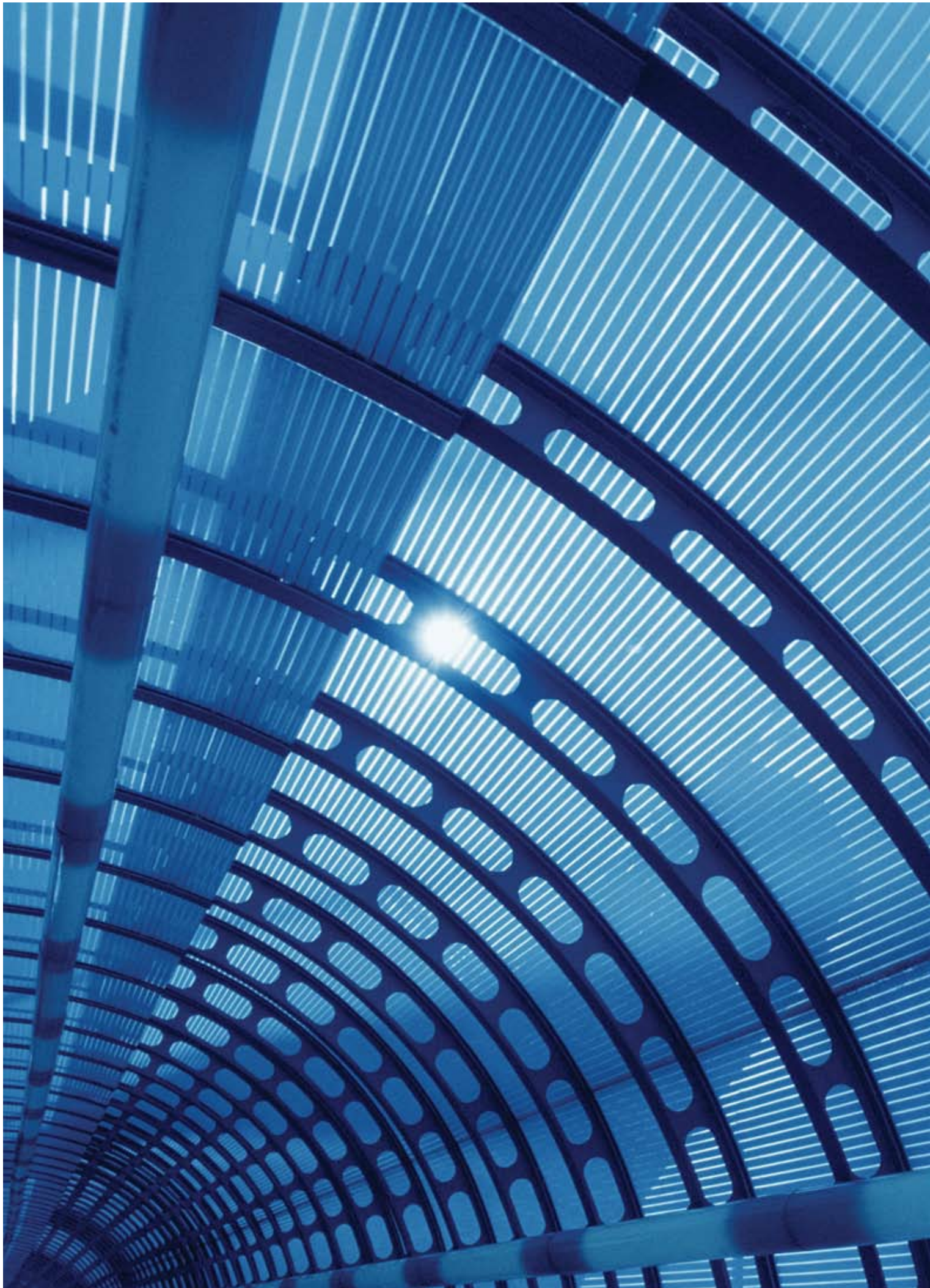
Many investors have indicated they welcome these changes brought about by Reg AB as an attempt to create transparency in the market and to have a uniform measure in the evaluation of servicing attributes. The road ahead for servicers will require greater levels of internal scrutiny and evaluation, and compliance in the initial year may be challenging for some companies as improvements to processes and systems may be necessary to ensure and demonstrate compliance.

In some cases, diversity remains in the definition of critical terms; however, their interpretation should be broad-based to ensure compliance. It is essential that all servicers clearly understand and define their roles in the transaction and what is required of them as a result. Companies are encouraged to think about their platform definitions—not too broad, not too narrow—and to ensure that all parties impacted by the servicing criteria are notified and expectations managed.

An emerging best practice is to create a matrix of the criteria, denoting each party required to assert compliance. Perform an internal assessment of your company's ability to adopt these principles and evaluate the controls that are in place to ensure that the assessment and assertion covers the role your company plays in the servicing of assets under the transaction agreements.

While there remain several key questions and issues that may require further clarification around Reg AB and its implementation, the various industry, accounting firms, and legal constituents will continue to resolve these items in the coming months. The process of how information will be reported, by whom and when it will be reported, will be challenging as the industry makes its first attempts at asserting compliance with the new criteria, and the accounting firms prepare their initial year attestation reports.







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Our dedicated Reg AB specialists can provide a full range of services from initial scoping and project managing implementation to carrying out attestation engagements. Our team has worked both in the US and UK and has first hand experience of carrying out all aspects of the work. For those clients who are not required to comply with Reg AB we can also provide a comprehensive range of services in relation to securitisation servicing and investor reporting.

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