NOMURA

ABS/MBS Disclosure Update #3:
Start Your Engines—Get Ready to Comment

10 May 2004

I. Introduction

This note supplements our reports of 29 April 2004 and 5 May 2004.

Last week the SEC published its long-awaited proposal to codify, amend, and harmonize the registration, disclosure, and reporting requirements for asset-backed and mortgage-backed securities. The release is available online at http://www.sec.gov/rules/proposed/33-8419.htm.

Certain market participants are starting to voice their opposition to features of the proposal:

- Major MBS issuers are likely to oppose required disclosures concerning 10% primary servicers (*i.e.*, a servicer that services 10% or more of the loans in a pool)
- Mortgage loan aggregators (*e.g.*, investment banks) are likely to oppose to the required disclosure of static pool performance data.
- Servicers in general are likely to oppose to the new assessment and attestation requirements related to their servicing functions.

With respect to the foregoing issues, we like the SEC's proposal as it stands. We don't believe that it should be narrowed. Rather, in some areas, it arguably should be expanded.

II. Discussion

10% Primary Servicer Disclosure: The proposed rules would require an issuer to include detailed disclosure about each primary servicer that services 10% or more of a securitized asset pool.[1] Major MBS issuers probably will assert that providing such disclosure would be burdensome and unnecessary.

The argument probably will go something like this: Unlike off-the-run ABS sectors, MBS backed by prime-quality mortgage loans have remained free of servicing scandals. Servicing prime-quality mortgage loans is straightforward and mechanistic. The servicing process is essentially the same at different companies and does not exert a strong influence on the overall credit performance of prime-quality mortgage pools. Moreover, an MBS issuer that pools loans from many unaffiliated primary servicers should not have to be responsible for the accuracy of detailed information about each one that services more than 10% of a pool. Requiring a major MBS issuer to collect information about 10% primary servicers could make the MBS issuer less competitive as a loan purchaser if other purchasers do not have to collect such information. In addition, requiring such disclosure will increase costs and hurt the efficiency of the private-label MBS market.

On the other hand, the arguments in favor of the proposed disclosure appear just as strong: An MBS issuer that really wants to avoid making the disclosure can do so by keeping primary servicer

Contacts:
Mark Adelson
(212) 667-2337
madelson@us.nomura.com

Nomura Securities International, Inc.
Two World Financial Center
Building B
New York, NY 10281-1198
Fax: (212) 667-1046

[1] *See* proposed Item 1107 to regulation S-K and discussion in part III.B.3.d of the SEC release.

concentrations below 10%. The issuer itself can assume the primary servicing role for a portion of the loans in a pool so that no unaffiliated primary servicer handles 10% or more. Between investors and an MBS issuer, the issuer is in a better position to get information about 10% primary servicers. Moreover, because the issuer is the one selling securities (and presumably making a profit in the process), it *should* be the party responsible for the accuracy and completeness of information on 10% primary servicers. The fact that the rating agencies rate primary servicers of prime-quality mortgage loans suggests that the activity is not trivially simple and that it has more than a trifling impact on loan performance.[2] If the SEC allows a loophole for prime-quality MBS, companies involved with other assets will push for their own loopholes and eventually undermine the new disclosure system.

Static Pool Performance Data of Mortgage Aggregators: The proposal calls for disclosure of static pool data by a transaction's sponsor.[3] Mortgage aggregators, such as investment banks, are likely to resist the proposed disclosure arguing that it could be misleading to investors. However, even from an investment bank, static pool performance data remains one of the most valuable forms of information for MBS investors.

Consider two hypothetical companies:

1. The first is a mortgage company that securitizes its loan production each month. The mortgage company has a retail operation through which it originates loans by direct contact with borrowers. The mortgage company also has a wholesale division in which it originates loans through mortgage brokers and correspondents. The mortgage company has loan underwriting guidelines that it applies to all its loans, except for cases where it specifically decides to make exceptions. The company delegates underwriting responsibility to certain correspondents. Each month the company pools its mortgage loans to create one or more MBS issues, which it sells through Wall Street securities dealers to institutional investors.

2. The second hypothetical company is a Wall Street investment bank that purchases loans from many different sellers. The investment bank does not apply its own mortgage underwriting standards but rather adjusts the purchase price that it will pay to reflect the quality of a pool. Each month the investment bank pools its mortgage loans to create one or more MBS issues, which it sells to institutional investors.

The investment bank might argue that it should not have to disclose static pool performance data about its prior deals because such data could be misleading to investors. The fact that the investment bank does not apply any loan underwriting criteria of its own when it purchases loans means that the characteristics of its pools – and their subsequent performance – can vary substantially from month to month. Static pool data about the loans securitized in any given month might not be indicative of the performance that investors should expect of subsequent pools.

On the other hand, the substantial performance volatility of securitized pools from the investment bank is exactly why investors need static pool disclosure. Investors should receive sufficient information to determine whether an issuer produces deals of stable and consistent quality or deals of widely varying quality.

Static pool data from the hypothetical mortgage company should reflect the company's success (or not) in applying its loan underwriting criteria over time and, potentially, the evolution of the criteria themselves. Static pool data from the hypothetical mortgage company may show that the company produces mortgage pools of relatively even quality, month after month.

---

[2] Crowe, T., Grohotolski, J., and Yan, C., *2003 Review and 2004 Outlook: Residential Mortgage Servicing*, Moody's special report (20 Jan 2004). As of 9 May 2004, Standard & Poor's maintained residential servicer evaluations on the following entities (among others): ABN AMRO Mortgage Group, Bank of America Mortgage, Cendant Mortgage, Chase Manhattan Mortgage, CitiMortgage, Countrywide Home Loans, First Horizon, Taylor Bean, and Wells Fargo.

[3] *See* proposed Item 1104(e) to Regulation S-K and discussion in part III.B.3.a of the SEC release.

Investors should have the opportunity to compare the static pool performance data from different companies in order to tell which tend to perform better or worse ***and*** to tell which display stable or erratic performance. Investors will need to see static pool data from all kinds of MBS issuers to make such comparisons most meaningful and helpful.

Presentation of Static Pool Data: The most active ABS/MBS issuers may argue that including static pool performance data in individual deal prospectuses is excessively burdensome. They may argue that they should be allowed to refer investors to information presented on their websites.

That solution could be acceptable if a few protective features are added. The federal securities laws have long employed the device of "incorporation by reference" to allow companies to fulfill disclosure obligations in a new filing by referring to previously filed materials. ABS/MBS issuers should be allowed to incorporate static pool performance data by reference ***if*** they have previously filed such data with the SEC. ABS/MBS issuers should not be allowed to incorporate by reference information that has not been filed.

The problem with incorporating by reference information from an ABS/MBS issuer's website is that the information is not preserved in a fixed form. Misstatements or omissions might not be preserved as the website gets periodically updated. Unfortunately, the market has experienced instances of incomplete or inaccurate information on company web sites.[4] Investors should be protected by preserving the state of available information at the time they purchase securities.

Annual Servicing Review: Many ABS/MBS issuers are likely to resist the proposed expansion of servicing compliance reviews. The proposal calls for a significantly expanded examination of servicing compliance and provides for both an "assessment" by a responsible party as well as an accountant's "attestation" each year.[5] At the February securitization conferences, a representative of the staff hinted that the SEC's proposal could contain such provisions.[6] The proposal would replace existing standards for evaluating servicing compliance with a new standard created by the SEC. The proposal would essentially scrap the venerable USAP[7] as well as the customized assessment criteria used in some transactions pursuant to no-action letter guidance.

ABS/MBS issuers are likely to oppose the servicing compliance aspects of the proposal for several reasons. Fulfilling the proposed requirements will undoubtedly be more expensive than fulfilling existing ones. Existing requirements (such as the USAP) set a fairly low standard for assessing and reporting on servicing compliance. Virtually any standard that the SEC could have embraced would have been more extensive than the USAP. However, the market's experience with servicer-related problems – including NCFE,[8] AMS,[9] and DVI[10] – highlights the need to enhance the servicing review process.

---

4 *See, e.g.*, Teicher, D., et al., *Theme and Variation – Understanding Why Credit Enhancement Levels Vary Among Jumbo MBS Issuers*, Moody's special report at 14 & n. 10 (18 Sep 1998).

5 *See* proposed Items 1120 and 1121 to Regulation S-K, proposed Rules 13a-18 and 15d-18, and discussion in part III.D.7.b of the SEC release.

6 *Report from Arizona 2004: Coverage of Selected Sessions of the Winter Securitization Conferences*, Nomura fixed income research, p. 23 (10 Feb 2004).

7 Mortgage Bankers Association of America, *Uniform Single Attestation Program for Mortgage Bankers* (1 Jan 1995).

8 *In re National Century Financial Enterprises*, No. 02-65235 (Bankr. S.D. Ohio). National Century Financial Enterprises (NCFE) filed for bankruptcy in November of 2002. Previously, the company had completed dozens of purported healthcare securitizations. The company and its principals have been accused of fraud in connection with those deals. Roughly $3.35 billion of outstanding securities have defaulted, and estimates of ultimate losses to investors have run higher than 85%. The main component of the alleged fraud is that collateral for the deals either was ineligible or did not exist. The revolving nature of the collateral pools combined with the absence of meaningful third-party oversight arguably enabled NCFE to perpetrate that aspect of the fraud. A secondary aspect of the NCFE fraud involves the company's diversion of reserve funds that formed a part of its deals' credit enhancement. Investors have alleged that the trustees for the NCFE deals should have prevented the company's diversion of the reserve fund balances. *See City of Chandler et al. v. Bank One et al.*, No. CV2003-010173, (Ariz. Superior Ct. Maricopa County, *filed* 23 May 2003).

Modifications, Extensions, & Repurchases: Significantly, the proposed annual servicing review covers the subject of loan modifications.[11] However, the SEC did not cover that subject sufficiently in connection with disclosure of static pool performance data and in connection with administering triggers in deals. As investors have learned, ABS/MBS issuers have sometimes manipulated reported performance and triggers by modifying, extending or repurchasing delinquent loans. To make static pool data most meaningful, it arguably should be presented with a complete break-out of all related modifications, extensions and repurchases.

Servicing Fees: The SEC's proposal for annual servicing reviews does not require an assessment of whether a deal's servicing fee is sufficient to cover the actual cost of servicing. That arguably should have been included in light of the recent problems of inadequate servicing fees in manufactured housing deals from Conseco[12] and the credit deals from NextCard,[13] and Spiegel/First Consumers.[14]

III. Conclusion

The proposal ought to appear in the Federal Register in the next day or two. That will officially start the clock on the 60-day comment period. However, for market participants who plan to submit comments, the extra one or two days should not make any difference. The comments on the proposal are likely to be very important in shaping the final rules. We suggest that anyone who plans to submit a comment start working on it at once.

The SEC proposal and its improvements in ABS/MBS disclosure are 100% real. Although their final form might be different, the improved paradigm is likely to survive the comment process and become a permanent feature of the ABS/MBS landscape. Now there's no turning back – *jacta alea est…*[15]

— E N D —

[9] In the troubled student loan transactions from Academic Management Services (AMS), the problem was in reinvesting collections in new loans during revolving periods of the deals. In the process, AMS brought ineligible (uninsured) collateral into the deals. The problem is that there was no "second set of eyes" checking the new collateral as it flowed into the deals. *See generally*, Sharon Asch, *2003 Review and 2004 Outlook: Student Loan-Backed Securities Growth to Continue*, Moody's special report at 6-7 (20 Jan 2004).

[10] DVI is accused of serious improprieties in connection with its securitization of medical equipment leases. *See* DVI, Inc., Current Report on Form 8-K, Exhibit 99.1 (8 Apr 2004) (Report of Chapter 11 Examiner Todd Neilson prepared in connection with *In re DVI, Inc.*, No. 03-12656 (Bankr. D. Del. 2003)).

[11] *See*, proposed Item 1120(d)(4)(vi) to Regulation S-K.

[12] Conseco's manufactured housing ABS performed badly and Conseco filed for bankruptcy. The servicing fee dwindled because it was subordinated to the securities. The company managed to convince the bankruptcy court to restructure the servicing fee. The court moved the servicing fee to the top of the cash flow waterfall and increased it to 125 basis points (declining to 115 bps). *See In re Conseco, Inc., et al.*, No. 02-49672 (Bankr. N.D. Ill. 2002).

[13] After the FDIC closed NextCard, the FDIC's actual servicing cost of the card portfolio exceeded the servicing fees. *See*, Office of Inspector General, Federal Deposit Insurance Corporation, *The Division of Resolutions and Receiverships' Resolution and Management of Credit Card Portfolios (Audit Report No. 03-029)*, (17 Apr 2003) (http://www.fdic.gov/oig/a-rep03/03-029-508.html).

[14] The OCC raised the servicing fees on the Spiegel and First Consumers credit card deals. In the matter of First Consumers National Bank, Beaverton, Oregon, Consent Order, Dept. of the Treasury, Office of the Comptroller of the Currency (15 Apr 2003) (http://www.occ.treas.gov/ftp/eas/ea2003%2D39.pdf); Spiegel, Inc., Current Report on Form 8-K, Exhibit 99-2, Independent Examiner's Report (12 Sep 2003) (the Independent Examiner's Report was prepared in connection with *S.E.C v. Spiegel, Inc.*, No. 03 C 1685 (N.D. Ill. 5 Sep 2003)).

[15] "The die is cast." Julius Caesar upon crossing the Rubicon into Italy on 11 Jan 49 B.C.E.

IV. Recent Nomura Fixed Income Research

Fixed Income General Topics

- ABS/MBS Disclosure Update #2 (5 May 2004)
- ABS/MBS Disclosure Update (29 April 2004)
- Report from Arizona 2004: Coverage of Selected Sessions of the Winter Securitization Conferences (10 February 2004)
- U.S. Fixed Income 2004 Outlook/2003 Review (18 December 2003)
- NERA Study of Structured Finance Ratings – Market Implications (6 November 2003)
- U.S. Fixed Income 2003 Mid-Year Outlook/Review (27 June 2003)
- Off-Balance Sheet Update (24 November 2003)
- NERA Study of Structured Finance Ratings – Market Implications (6 November 2003)

MBS

- Monthly Update on FHA/VA Reperforming Mortgages: Historical Prepayment Speeds, Default Losses, and Total Returns (5 February 2004)
- Australian MBS Primer (9 September 2003)
- Agency Capped Callable LIBOR Floaters Offer Structuring Flexibility to Create Investment Profiles That May Be Difficult to Create in New Issue CMO Floaters (2 July 2003)
- A Journey to the Alt-A Zone (3 June 2003)

CMBS

- Update: Have the Courts Upheld Prepayment Premiums and Defeasance Provisions? (28 January 2004)
- GNMA Project Loan Prepayment Report (15 January 2004)
- GNPL REMIC Factor Comparison (28 October 2003)
- CMBS Watchlistings, Downgrades, and Surveillance (2 October 2003)
- Temporal Aspects of CMBS Downgrades and Surveillance (1 July 2003)
- Some Investment Characteristics of GNMA Project Loan Securities (1 May 2003)
- CMBS Credit Migrations (4 December 2002)

ABS

- ABS Gold Coast Report: Coverage of Selected Sessions of ABS East 2003 (20 October 2003)
- What a Coincidence? – One Reason Why CDOs and ABS Backed by Aircraft, Franchise Loans, and 12b 1 Fees Performed Poorly in 2002 (19 May 2003)

Corporates

- U.S. Corporate Monthly - January (11 February 2004)
- U.S. Corporate Monthly - December (9 January 2004)
- U.S. Corporate Monthly - November (8 December 2003)
- Toys "R" Us, Inc. - (18 November 2003)
- U.S. Corporate Monthly - October (10 November 2003)
- Ford Motor Co./Credit Corp. - (17 October 2003)
- U.S. Corporate Monthly – September (8 October 2003)
- Nomura Credit Quarterly – September 2003
- U.S. Corporate Monthly – June (9 July 2003)

Strategy

- Callable Agencies – Calculating The Probability of Call (4 May 2004)
- TIPs Bonds: A Way to Beat Inflation (28 April 2004)
- Balancing Yield and Liquidity within Investor Portfolios (23 April 2004)
- Reviewing the MBA Refinancing Index (23 April 2004)
- Using Interest Rate Swaps as a Portfolio Duration Tool (19 April 2004)
- MBS Market Check-up: “The Sequel” (16 April 2004)
- Z Spread: An Important Tool in a Shifting Yield Curve Environment (15 April 2004)
- CMBS Loan Delinquency Update (15 April 2004)
- Cross-Sector Breakeven Spread Widening Analysis (5 April 2004)
- Without Partiality (Pari-Passu) (1 April 2004)
- Callable Agencies: A New Approach (26 March 2004)
- MBS Market Check-up (18 March 2004)
- CMBS Asset Swap (18 March 2004)
- Value in Rocket Z Bonds (15 March 2004)
- Structured Product CDO Spreads Should Tighten (5 March 2004)
- Is Extension Risk Around the Corner? (1 March 2004)
- Value in Short Non-Agency Sequentials (27 February 2004)
- Value in Seasoned CMBS (24 February 2004)

NOMURA

NEW YORK	TOKYO	LONDON
Nomura Securities International	Nomura Securities Company	Nomura International PLC
2 World Financial Center, Building B	2-2-2, Otemachi, Chiyoda-Ku	Nomura House
New York, NY 10281	Tokyo, Japan 100-8130	1 St Martin's-le-grand
(212) 667-9300	81 3 3211 1811	London EC1A 4NP
		44 207 521 2000

Nomura Fixed Income Research

New York

David P. Jacob	(212) 667 2255	International Head of Research
David Resler	(212) 667 2415	Head of U.S. Economic Research
Mark Adelson	(212) 667 2337	Securitization/ABS Research
John Dunlevy	(212) 667 9298	Structured Products Strategist
Arthur Q. Frank	(212) 667 1477	MBS Research
Louis (Trey) Ott	(212) 667 9521	Corporate Bond Research
Parul Jain	(212) 667 2418	Deputy Chief Economist
Weimin Jin		Quantitative Analyst
Michiko Whetten	(212) 667 2338	Quantitative Credit Analyst
James Manzi	(212) 667 2231	Analyst
Elizabeth Hoyt	(212) 667 2339	Analyst
Edward Santevecchi	(212) 667 1314	Analyst
Tim Lu		Analyst
Kumiko Kimura	(212) 667 9088	Translator
Tomoko Nago-Kern	(212) 667 9894	Translator

Tokyo

Nobuyuki Tsutsumi	81 3 3211 1811	ABS Research

London

John Higgins	44 207 521 2534	Head of Research - Europe

I Mark Adelson, a research analyst employed by Nomura Securities International, Inc., hereby certify that all of the views expressed in this research report accurately reflect my personal views about any and all of the subject securities or issuers discussed herein. In addition, I hereby certify that no part of my compensation was, is, or will be, directly or indirectly related to the specific recommendations or views that I have expressed in this research report.