American Securitization Forum
Recommended Market Standards and Practices: Disclosure and Periodic Reporting for Home Equity Loan ABS with Collateral-Based Performance Triggers

March 2006

Introduction and Background

Based on widespread member input, the American Securitization Forum[1] ("ASF") created a Home Equity Loan ABS ("HEL") Triggers Task Force to undertake a project aimed at promoting clearer and more consistent industry awareness, understanding, and usage of definitions, terminology and descriptions of different collateral-based performance trigger mechanisms that alter allocation of cashflows in HEL transactions. This document is the result of such efforts.

The goal of this project is to help the industry identify and promote recommended "best practices" for the presentation and description of HEL trigger mechanisms in offering documents, deal documents, and post-issuance reports. The ASF does not intend to standardize the types or features of trigger mechanisms used in the marketplace or to identify or recommend "good" or "bad" triggers, but instead to promote more transparent descriptions, and better understanding, of the trigger mechanisms actually in use. With greater transparency, understanding and common usage of terminology, the ASF believes that investors and other market participants will be in a better position to evaluate the merits of different trigger mechanisms for themselves.

The ASF believes that these outcomes can contribute to greater comfort among investors and other market participants regarding the intended and actual operation of HEL triggers, and greater liquidity and efficiency throughout the HEL primary and secondary markets.

1 The ASF is a broadly-based professional forum through which participants in the U.S. securitization market can advocate their common interests on important legal, regulatory and market practice issues. The ASF seeks to build consensus, coordinate advocacy efforts, and inform and educate the securitization community and related constituencies on issues of broad importance to the industry. Members of the ASF include investors, issuers, financial intermediaries, accounting firms, law firms, trustees, mortgage insurers, financial guarantors, rating agencies and other securitization-related entities. More detailed information on the ASF, its membership, and activities may be found on our website at www.americansecuritization.com.

Typical HEL Structures and Triggers

Structures that utilize excess spread and over-collateralization as a form of credit enhancement are common in securitization of sub-prime residential mortgages (and more specifically home equity loans). These transactions typically allow for principal reduction of mezzanine and subordinate bonds while the senior-most bond is outstanding after a specified step down date (often after 3 years). Most transactions of this type employ Trigger Events[2] tied to collateral delinquency and loss performance that will alter the base cashflow allocation method and maintain over-collateralization if there is deterioration in the performance of the collateral in order to protect higher rated bonds.

There are typically two types of Trigger Events: a Cumulative Loss Trigger Event and a Delinquency Trigger Event. A Cumulative Loss Trigger Event occurs if cumulative losses on a collateral pool exceed a specified level of losses. A Delinquency Trigger Event occurs when a measure of delinquency as a percentage of current balance exceeds a specified number (or series of numbers or a formula based calculation, often based on a specified credit enhancement measure). When a Trigger Event occurs, over-collateralization is not allowed to step down and the base waterfall is altered whereby distributions are allocated in a different manner generally intended to protect the senior-most classes.

The occurrence of a Trigger Event impacts senior, mezzanine, subordinate, residual, and net-interest margin (NIM) holders in different ways. Senior class bondholders benefit from the maintenance of credit enhancement. Mezzanine and subordinate bondholders also benefit from the maintenance of credit enhancement but are subject to average life extension because they continue to receive no principal payments for the duration of the failed trigger. Generally speaking, residual and NIM holders are negatively impacted since cash that would otherwise be directed to them is redirected to the senior-most bondholders. It is important to understand that different bondholders may have conflicting interests with respect to the Trigger Events and that the measurement of loan performance and the mechanics of the Triggers should be very clearly specified to promote transparency among transaction participants.

A large proportion of the transactions contemplated by this document use a credit enhancement trigger as a part of the step down determination. Examples of this trigger, which are generally used in conjunction with the later of the trigger and a static date, include a Trigger Event when the credit enhancement of triple-A rated bonds become smaller than the target percentage or when the credit enhancement of double-A and lower rated bonds become greater than the target percentage. The usage of these types of triggers is very common.

This document sets forth recommendations focusing on offering materials and ongoing investor reporting through remittance reports. These recommendations take the form of both

[2] Capitalized terms used herein should be specifically defined when/as used in disclosure and operating documents.

statements articulating best practices and questions that offering materials and remittance reports should answer.

Offering Materials and Operating Documents

1. The term sheet, offering circular or prospectus supplement, and pooling and servicing agreement or indenture should describe the Trigger Events consistently and fully. Specifically, the trigger language should be disclosed in: (1) preliminary marketing materials such a term sheet, (2) prospectus supplement and (3) pooling and servicing agreement in sufficient detail using substantially similar (if not identical), defined terms.

    A. In cases where disclosure in preliminary marketing materials might be tentative and/or incomplete as compared to what would be included in the preliminary and final prospectus or pooling and servicing agreement, the materials in question should acknowledge this fact.

        i. For example, if precise trigger levels as determined by the rating agencies will not be available at the time the transaction enters the market, the term sheet should disclose this fact.

2. Disclosure on the measurement used to represent delinquencies in the numerator of the Delinquency Trigger Event should answer:

    A. Whether or not delinquencies are calculated using the MBA or OTS methodology.

    B. Whether or not REO, Bankruptcies and/or Foreclosures are included as delinquent loans.

        i. The term "Bankruptcy" should be clearly defined.

    C. With regard to special status loans such as Foreclosure and Bankruptcy, whether all loans are included in the 60+ trigger or only those that are contractually delinquent.

    D. With regard to loans in repayment plans, what the 60+ number includes with respect to contractually delinquencies, repayment terms, modified loans, etc.

    E. How modified mortgages are added and treated with respect to delinquencies.

        i. For a formally modified loan, the calculation should be based on the terms of the modified loan and policies of the lender.

        ii. Whether regulatory requirements impose limits on the number of modifications that can be made.

3. Other trigger related measures and issues include the following:

    A. Offering materials and documents should clearly explain how the Delinquency Trigger Event breach is calculated and clearly specify the denominator definition.

Delinquency triggers are normally expressed as a percentage of Credit Support. There are several different ways Credit Support can be defined:

i. Use of Dynamic Senior Credit Support, which is typically defined as *originally* subordinated bonds divided by current collateral balance. Using this definition, if the original senior bonds pay off, the Senior Credit Support would be 100%.

ii. Use of Static Senior Credit Support, so that if required Senior Credit Support must be at least 40%, the trigger is evaluated against that fixed number.

iii. Use of Float Down Senior Credit Support, where rather than looking at the original senior classes, the Senior Credit Support would be based on the then outstanding senior class. For example, if the triple-A bond classes payoff and the double-A classes are the most senior bonds, Senior Credit Support would be calculated by adding the single-A classes and below bonds and over-collateralization divided by the collateral balance.

B. The calculated initial level of breach should be clearly disclosed.

C. Offering materials and documents should clearly indicate whether the Trigger Event is based on current period or a rolling average.

D. Offering materials and documents should clearly specify the permitted ratio of delinquencies to Credit Support.

i. For example, delinquencies are usually permitted to be a maximum percentage of Credit Support – generally 40%-50% (e.g. trigger fails if 60+ delinquencies are greater than 50% of Credit Support). This should be clearly defined. This is sometimes also expressed in the converse (e.g. trigger fails if the delinquencies more than double the Credit Support).

ii. For transactions in which the permitted ratio changes to the most senior class outstanding when the original senior class equals zero, disclosures should be consistent with the desired level of disclosure standards.

4. Disclosure on the Cumulative Loss Trigger Event should answer the following:

A. The level during each period that breaches the Trigger Event.

i. Disclosures should address whether this level adjusts annually, or if there is linear interpolation between annual periods or some other method of establishing this level.

B. The operating documents should provide targeted values for all components of tests for all periods.

i. For example, cumulative loss schedules should prescribe targeted values for the periods prior to the step down date.

C. When the Cumulative Loss schedule begins. Some Cumulative Loss triggers start in year two while others start in year three.

D. The specific definition of Realized Loss.

i. The method for determining when a loss is realized and included in the cumulative loss calculation should be clearly disclosed.

ii. It should address how Realized Losses and subsequent recoveries are applied, including whether interest accrues on the Realized Loss, and if so, what is used to pay the accrued interest.

5. Disclosure of the impact of Trigger Event occurrence should clearly include the following:

A. The impact of triggers failing.

i. The alteration in waterfall due to a breach of a Trigger Event in the waterfall section of the offering and operating documents.

ii. Specified step down and/or step up provisions, including whether the deal allows step downs and/or step ups before the end of year three if the senior class pays off.

B. The impact on over-collateralization, especially in instances where over-collateralization is used to pay principal on senior-most certificates.

i. Payment priority and application of excess cash flow for passing/failing triggers; and

ii. Whether over-collateralization is required to step up to a higher level.

6. Disclosure on whether the trigger is curable or permanent should be clearly explained.

7. Disclosure on items that result in potential conflict of interest should include the following:

A. The right to buy back loans, encompassing

i. Who has the right to buy back loans;

ii. What limitations or restrictions are imposed on the right to buy back loans; and

iii. Whether the rights to buy back loans can be provided to someone in the future if such rights do not exist at the time of deal closure.

B. Whether the underlying mortgage may be modified. In particular, whether there are any limitations or restrictions on servicer's ability to modify loans.

Ongoing Reporting in Remittance Reports

- Terms used in remittance reports should be identical as those used in the pooling and servicing agreement
    1. For example, if the pooling and servicing agreement utilizes the term "senior enhancement percentage," the corresponding term in the remittance report should be "senior enhancement percentage" and not "Senior Credit Support."

- The calculation agent or other provider of remittance reports should show each element of the Delinquency Trigger Event and Cumulative Loss Trigger Event calculations for the current and all past periods required for any rolling average calculation used.

- The remittance report should clearly show actual versus targeted amount and indicate clearly whether the trigger is passing or failing.
    1. This should be shown prior to step down date.

- Where multiple triggers exist (as is common in most deals) the remittance report should also indicate whether overall trigger is failing – e.g. if the delinquency trigger is passing and the cumulative loss trigger is failing, the remittance report should show overall trigger fails if an "or" trigger is used (some deals are "and" triggers and would fail only if both triggers fail).

- A recommended disclosure list for remittance reports, which should be included in the list of reportable items found in the operative document(s), is as follows:

    <u>Delinquency Trigger</u>
    1. Delinquency Numerator
    2. In the case of a rolling averages, disclosure of each month that is used to calculate rolling average for delinquency numerator
    3. Delinquency Denominator
    4. Delinquency Percentage
    5. Trigger Test Formula Input Value (e.g. Senior Credit Enhancement Percentage)
    6. Trigger Failure Level
    7. Difference between Trigger Failure Level and Delinquency Percentage, when reasonably applicable
    8. Additional Delinquencies in Numerator that would result in Failure, except for rolling calculations
    9. Delinquency Trigger (Pass/Fail)

10. Whether REO, Bankruptcies and/or Foreclosures are included as delinquent loans

Cumulative Loss Trigger

11. Next cumulative loss schedule change date
12. Next cumulative loss schedule threshold
13. Cumulative Loss Numerator
14. Cumulative Loss Denominator
15. Cumulative Loss Percentage
16. Cumulative Loss Failure Level
17. Cumulative Loss Trigger (Pass/Fail)
18. Severity of loss current for 3, 6, 12 months and life

Other

19. Excess spread information
20. The number/amount of loans that have been "bought out" in a remittance period, along with cumulative "buy out" numbers.
21. Potential disclosure on who bought out the loans - servicer or a third party investor.
22. The number/amount of loans that have been modified.
23. Type of modification: rate, term, other.