Moody's Proposes Enhancements to Non-Prime RMBS Securitization

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SUMMARY OPINION

The current turmoil in global credit markets has invited concern about both the lending methods by which subprime residential mortgage loans are originated and the securitization process by which pools of residential mortgage loans are packaged into residential mortgage-backed securities (RMBS) and related structured finance products.

While the sharp decline in home prices and contraction of mortgage credit availability across much of the U.S. have been key factors behind the current crisis, numerous market sources have identified certain market practices - lenient lending practices by mortgage originators and misrepresentations by certain mortgage brokers, appraisers and the borrowers themselves - as also contributing to the unexpectedly poor payment performance of recent subprime mortgage loans.

During the past several months we have met with mortgage originators, fixed-income investors, investment bankers, oversight authorities and policymakers to discuss measures that would help restore confidence in credit markets, including the structured finance market. The results of those meetings and Moody's subsequent internal deliberations form the foundation for the actions and recommendations that follow. We are soliciting reactions and further suggestions and look forward to working with market participants, industry trade organizations, and oversight authorities on these and other proposals. Please forward your comments to cpc@moodys.com.

- To increase transparency around the quality of each lender's underwriting standards and the reliability of information used in evaluating the credit characteristics of subprime mortgage pools, Moody's will now look for additional third-party oversight that reviews the accuracy of the information provided by borrowers, appraisers and brokers to originators.
- Moody's will look for loan originators and issuers of non-prime mortgage-backed securitizations requesting ratings from Moody's to provide investors stronger and more uniform representations and warranties that the loan information provided to investors is accurate and that the loans included in the transaction were appropriate for the borrowers. A third party, such as the trustee, the master servicer or a credit risk manager should have the responsibility and the appropriate incentives to monitor and to enforce those representations and warranties.
- Moody's believes the market will benefit from increased transparency about individual loan characteristics and performance. Moody's historically has received loan level information prior to the closing of a mortgage-backed transaction and monthly summary information on mortgage pool performance thereafter. More recently, post closing, Moody's has begun receiving monthly loan

level performance information. Prospectively, Moody's will look for servicers to provide us such monthly loan level performance information for all newly originated RMBS transactions. Moody's also recommends that for public transactions, loan level information both prior to closing and throughout the life of the transaction be provided to all transaction participants requesting it. In addition, performance reports on RMBS transactions should be standardized by securitization sponsors and expanded in scope. Increasing transparency on transactions and pool performance would reduce uncertainty, support secondary market liquidity for well-performing pools and thereby enhance investor confidence during periods of stress.

Although recent performance problems have been concentrated in the subprime mortgage market, and the proposals in this report are focused on that market, we believe the changes contemplated here are potentially applicable to securitizations of other types of non-prime assets, such as non-prime auto loans, certain private student loans and non-prime credit card receivables. Weaknesses that have surfaced in the subprime mortgage market could possibly manifest themselves in other non-prime markets in the future. Moody's will consider whether these principles should apply to other markets and will solicit the views of market participants and oversight authorities through a "request for comment" proposal to be issued shortly.

NEED FOR THIRD-PARTY LOAN REVIEWS

To improve the accuracy of loan information upon which it relies, Moody's will look for additional oversight by a qualified third party. As Moody's is not involved during the actual origination of the loans being included in a securitization, going forward we will make credit distinctions based on the presence of a third party review and on its findings. In Moody's view, the review findings should be available not just to us, but to investors and other transaction participants who request them.

An effective review could involve reviewing a sample of mortgages in a proposed transaction. A wide range of attributes should be analyzed as part of the review. For example, there would be a review, among other things, of the appraised home value, the borrower's credit history, and the reasonableness of the borrower's stated income. The review should also involve an assessment of whether the loan was originated in compliance with applicable law. A key part of the review should include contacting a sample of borrowers and confirming with each of them the terms of their loan, the income they stated in their loan application and whether the house is their primary residence.

IMPROVE REPRESENTATIONS AND WARRANTIES

The seller or originator in structured securities makes representations and warranties regarding the characteristics of the loans they sell into securitizations. In light of recent events, typical representations and warranties should be strengthened. In addition to other matters, the seller could provide representations and warranties to investors as to the quality and accuracy of all information presented to investors, rating agencies and other market participants.

The value of representations and warranties is diminished when made by entities that are not financially strong, as such entities may be less able to fulfill their obligation to repurchase loans that breach the representations and warranties. Moody's will make greater distinctions in its ratings and/or enhancement levels depending on the financial strength of the party providing the representations and warranties.

Moody's will also make distinctions based on the level of oversight regarding representations and warranties. Moody's believes the appointment of a third party, such as the trustee, the master servicer or a credit risk manager, to ensure that loans that breach representations and warranties are identified and "put back" to the sellers adds to the value of the representations and warranties.

In addition, Moody's believes the securitization market would benefit from oversight authorities addressing lenient underwriting and the potential for fraud through more stringent licensing and additional supervision of mortgage brokers.

ENHANCED REPORTING FOR INCREASED TRANSPARENCY

To date, performance reports provided on RMBS transactions have not been standardized and in some cases have been limited in scope. In addition, investors have raised the concern that RMBS transactions are sometimes too opaque because loan level information is not always available to them. This lack of transparency creates uncertainty and a lack of confidence among investors about which mortgage pools and transactions remain sound during periods of stress.

In our conversations with all market participants, the issue of transparency was raised time and again. To this end, we recommend that for public transactions loan level information both prior to closing and throughout the life of the transaction be provided to transaction participants. In addition, performance reports on RMBS transactions should be standardized by securitization sponsors and expanded in scope. Increasing transparency on transactions and pool performance would reduce uncertainty and boost investor confidence. Sharing the information with a wider audience will also increase the scrutiny on these transactions, which in turn should lead to better performance.

Moody's historically has received loan level information prior to a securitization's closing. More recently, post closing, Moody's has begun receiving monthly loan level performance information. Prospectively, we will look for servicers to provide such monthly loan level performance information to Moody's for all newly originated RMBS transactions. This additional information will improve the precision of Moody's rating monitoring processes.

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