by Neil A. O'Hara

The Teething Pains of Reg AB

One year in, the SEC's disclosure rule for ABS has revealed a couple of warts and socked issuers with unexpected costs. But it has also succeeded in one of its chief ambitions: giving investors more reliable information.

All new rules have one thing in common. They will never please everyone, despite how necessary they might be. That certainly seems to be the case with Regulation AB, the Securities and Exchange Commission's disclosure and reporting standard for mortgage-backed and asset-backed securities that took effect at the beginning of 2006. It has caused some unexpected costs and created other potholes for issuers and servicers. But despite these early teething pains, the new rule seems to have made progress in giving investors better access to reliable information.

Certainly, a new set of rules for the securitization markets was long overdue in the eyes of many participants. The previous framework was a hodgepodge of no-action letters, interpretive requests and other guidance. And much of that was derived from rules designed for equities or traditional fixed-income securities that did not address the unique characteristics of MBS and ABS.

Bringing a bit of fresh air to ABS essentials

Many welcomed replacing that with the more market-specific Reg AB. And the SEC also seized the opportunity to enshrine some common market practices in the new rule. Now servicers must pledge, for example, that they have performed all their contractual obligations — something many have done as a matter of course for some time — although Reg AB added the requirement that independent auditors sign off on servicers' statements.

Investors have largely cheered this, although it also shifts the balance somewhat. Reg AB has leveled the playing field by giving all market participants access to the same information, according to Sanjeev Handa, managing director and head of public fixed-income investments at TIAA-CREF. In the past, some information was not incorporated in the prospectus and was only made available to large investors upon request. Issuers had some wiggle room to escape liability if the information proved to be inaccurate, while small investors were left in the dark.

Today, any information given to one investor must be given to all. "Investors have to compete on their analytical ability, not their ability to get information from the issuer," says Handa, who oversees $140 billion in fixed income assets, including $38 bil-

lion in ABS and residential MBS as well as $17 billion in commercial MBS. Handa helped set up TIAA-CREF's structured finance trading desk in 1990; he isn't worried about the firm losing its competitive edge.

More important, though, is the effect the new disclosure rules have had on how investors regard the information now being provided. In the past, if static pool data were made available, it came with a disclaimer. "I always thought that was quirky,"

Reg AB has leveled the playing field by giving all market participants access to the same information. "Investors have to compete on their analytical ability, not their ability to get information from the issuer."

Sanjeev Handa, head of public fixed-income investments at TIAA-CREF

says Ralph Daloisio, a managing director in the New York-based structured finance group at Natixis, "I have a much higher willingness to rely on that information now that it is subject to Securities Act liability standards for accuracy, completeness and reliability."

By the same token, Daloisio, who has more than 15 years' experience in structured credit products and now manages a credit-sensitive ABS portfolio, has more confidence in servicer certification in the Reg AB world.

That confidence comes at a price, however. In its cost-benefit analysis of Reg AB, the SEC estimated that implementation would cost the industry less than $50 million. During the public comment period, nobody questioned that estimate. After all, if issuers were already providing much of the information, how much could it cost to comply?

A lot more than anyone thought, it turns out. For starters, issuers have to provide separate financial statements for special purpose subsidiaries that issue derivative instruments even if the entity has an unconditional guarantee from the parent company. During the implementation period the American Securitization Forum and other industry groups argued that parent company financial statements were sufficient because that's where the buck stops, but the SEC stuck with its policy. "That caught people off guard," says Michael Seelig, a partner in PricewaterhouseCoopers' consumer finance practice. "Most people thought it was a relatively easy and simple accommodation."

That's not the only example. Integrated firms that originate loans, repackage them into asset-backed securities and have their own servicing operations had access to all the historical data needed for static pool disclosure. But their systems did not capture it in the form the rule required. "It took quite a bit of effort and expense to comply," says Tom Knox, director of PricewaterhouseCoopers' structured finance group. "That's especially true for organizations that chose to go backwards in time to retrieve that data out of their systems." Although Reg AB let issuers off the hook if generating data before 2006 involved unreasonable effort or expense, some went back anyway to bolster the credibility of their securitization programs.

Other market participants, including the major Wall Street investment banks, that buy mortgages, credit card receivables and car loans from third-party originators faced a tougher obstacle: static pool data wasn't always available at any price. Some originators sell their loans service released, which means they no longer service the loans and aren't privy to the monthly performance information Reg AB demands. Knox, a 14-year industry veteran, says Wall Street sponsors had to parcel out service-released loans across multiple transactions to keep the concentration for each originator below the threshold that triggers static pool disclosure, a technique known as "spread and sprinkle."

Unexpected costs turned up in the preparation of periodic financial reports as well. Issuers of publicly traded securitizations have just completed the first annual cycle under Reg AB, in which obtaining servicer attestations proved more onerous than expected, according to PwC's Seelig, who has worked in structured finance for more than 12 years.

In the absence of regulatory guidance, the market used to rely on the Uniform Single Attestation Program (USAP) for servicers developed by the Mortgage Bankers Association. A standard devised for mortgage servicers fell short when applied to other asset classes, however — a deficiency the SEC sought to correct in Reg AB. The agency broadened the language to include assets other than mortgages and expanded the attestation to cover additional procedures in loan administration and the handling of defaulted receivables. Market participants nicknamed the new standard "USAP on steroids" for its extended reach, but it bulked up compliance costs as well because the new standard applies continuously rather than at year-end. "If you have a compliance issue during the course of the year, even if you fixed it, you still have to report it," Seelig explains.

Technological Overhaul

Reg AB forced many servicers to undergo a significant information technology overhaul. "Servicers had to adopt an entirely new scheme for capturing on a systematic basis whether they were satisfying each of 41 items of compliance," says Larry Rubenstein, general counsel of Wells Fargo Asset Securities Corp, one of the largest domestic issuers of MBS. Although the approach keeps servicers under constant pressure to monitor their performance, reports of minor technical infractions of little interest to investors tend to proliferate.

For the rating agencies, USAP on steroids brings the regulations in line with what they already required from top-rated servicers. "It reflects best practices," says Michael Gutierrez, managing director responsible for servicer evaluations at Standard & Poor's. At press time, servicer attestations for 2006 were still coming in to S&P, so the jury is out on the nature and severity of exceptions reported, but Gutierrez plans to review the

facts and circumstances in each case. Reason: a one-off exception that was cured and did not happen again would carry less weight than a recurring problem.

Reg AB casts a wide net because many servicing firms outsource some operations, but as long as third party vendors perform only non-discretionary functions the SEC has agreed to waive compliance. Although Gutierrez has seen servicers outsource call centers and other customer service operations, they keep in house functions like default management, which involves decisions about whether to pursue a workout or move to foreclose.

Complaints about the cost of Reg AB cut little ice with Daloisio, who feels that any entity engaged in the billing and collection process should be able to meet the attestation standards. Issuers should also be able to produce reliable static pool data as a matter of course. "If they can't, that's not a problem of the regulation. They have underinvested in their own systems and technology," Daloisio says, "It's deferred maintenance they didn't keep up."

Thanks to Reg AB, we now have a technique known as "spread and sprinkle" and a new standard called "USAP on steroids."

That view strikes a chord with other investors. To Dan Stachel, director of credit policy at State Street Global Advisors (SSGA), gripes about Reg AB compliance costs are symptomatic of a wider flaw among issuers and servicers in the ABS market: nobody wants to take responsibility for their actions even if investors get hurt. "It's not that bizarre a request to ask that a servicer knows what it is doing and has reviewed it," he says, "Everybody wants a 'Get Out of Jail Free' card on fraud."

Issuers have to file servicer assessments and auditor attestations as exhibits to their Form 10-K annual report, but in many cases those documents come from third parties outside the issuer's control, including credit enhancement providers, sub-servicers and other vendors. Pulling together all the documents in time to meet the 10-K filing deadline is a challenge. Brett Handelman, vice president of the structured products group at Wells Fargo Corporate Trust, a leading MBS master servicer, says that although his firm succeeded in making it happen for all the issuers it services, "as many as 95% required some sort of follow-up from Wells Fargo for further clarification or because of incomplete or erroneous information delivered."

The issuers who really need a free pass on attestations got caught in the backwash from the turmoil in the subprime mortgage market. For some distressed subprime originators, providing those documents has taken a back seat to more pressing concerns, leaving issuers to file 10-Ks with the SEC that are either late or incomplete.

What's the downside? Even though it wasn't an issuer's fault, a defective 10-K renders it ineligible for 12 months to file registration statements for future securitizations using Form S-3, the SEC's abbreviated format for seasoned issuers that incorporates most information by reference to other public filings. That's a Draconian sanction for issuers that need to be able to take down securities from their shelf registrations at the drop of a hat. Preventing them from doing so risks shutting off access to capital just when such firms could need it most. If Reg AB had an ugly side, this was it.

But the SEC recently worked out a solution with representatives from the ASF. Affected issuers can submit a letter stating that in their opinion the 10-K filings they made were "materially sufficient." In any event, issuers aren't always completely shut off from financing, according to Steven Kudenholdt, a partner in the New York office of Thatcher, Proffitt & Wood who chairs the law firm's structured finance practice. Although the issuer loses the ability to file a new S-3 for the next 12 months, it can still draw down securities from an existing shelf. "Many of the issuers took the precaution of increasing the amount registered on their shelves before the 10-Ks were due to make sure they had plenty of capacity to get through the next 12 months," Kudenholdt says.

Investors do have some concerns as well. Despite the benefits Reg AB brings them, it does introduce the risk that issuers find the disclosure requirements too burdensome. "Instead of providing a lot of information to everyone, the issuer can provide no information to anyone," says TIAA-CREF's Handa.

Or an issuer might take steps that seem to skirt the spirit of the disclosure rules. At the road shows SSGA's Stachel attends, issuers often deliver a presentation but don't leave copies behind for investors to take away. They are playing chicken. If they leave the books the content becomes part of the prospectus subject to Securities Act liability. "They are invalidating one of the major benefits that Reg AB gives," Stachel fumes. "So much information is really in the flipbook."

Of course none of the enormous increase in disclosure for publicly traded asset-backed securities mandated by Reg AB did anything to mitigate the problems in the subprime mortgage market. That is probably asking too much of a year-old provision when no one, whether borrowers, lenders, investors or regulators, paid sufficient heed to the warning signs. And to date at least, the fears that a broader swathe of issuers could switch to the private market to avoid the costs of Reg AB oversight appear not to have materialized. TIAA-CREF's Handa has certainly not seen any wholesale migration: "It's human nature to say it's too expensive. If they had said the opposite, then I'd be surprised." So for all the complaints from issuers about Reg AB's compliance costs, the early signs are that the SEC has struck a reasonable balance.

Neil A. O'Hara *is a freelance writer who has first-hand knowledge of domestic and international markets. He is a contributing editor to FTSE Global Markets and writes for various financial publications including On Wall Street, Wealth Manager and Alpha. He lives in Lincoln, Mass.*