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Securitization Will Come Back…
Will You Be Ready When It Does?

An Interim Report on Diligence and Surveillance Issues & Considerations

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No longer is the question: Will non-agency securitization come back? Now it's: When? What form will it take? And what interim steps should originators and investors be considering now in order to be ready?

While there are still a number of unknowns, the broad strokes of what will be required in terms of pre-securitization diligence and post-issuance performance monitoring are taking shape. This special report will review the due diligence requirements of Dodd-Frank, recent SEC proposals to strengthen Regulation AB, new rating agency policies, as well as industry recommendations from groups like the American Securitization Forum (ASF). These coming rules will create a new era of transparency and operational excellence—raising the bar for accuracy, validity and quality for both issuers and third-party reviewers.

This report will discuss the challenges that these new rules will create for issuers and originators. It will also review:

- Organizational changes that Clayton has already made to anticipate the higher bar that will be set for due diligence and credit risk management.
- Significant investments in technology that we have made over the past three years.
- Our commitment to clients, rating agencies and to the return of a robust RMBS market.

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New Rules for Due Diligence

Dodd-Frank and new due diligence requirements from the leading rating agencies will significantly enhance the diligence process going forward, providing investors with greater transparency.

The leading rating agencies, which historically had not incorporated diligence results in their rating, are now committed to integrating this data into their rating processes. As a result, each of the agencies has established new guidelines for:

- **Third-party reviewer (TPR) qualifications: experience levels of TPR team, assessment/approval of TPR firm, QC methodology, background checks/staff training**
- **Sampling**
- **Scope**
- **Seasoning**
- **Data uploads**
- **Reporting**
- **Attestation**

Similarly, the due diligence provisions in Dodd-Frank Section 945 and the rules and regulations thereunder mandate that the issuers conduct a loan-level review of the assets to be placed in a security. Specifically, Dodd-Frank's Rule 193 says:

The issuer itself or a third party can do the review.

If the issuer works with a third party, the issuer can elect to disclose who the third party is and attribute the third party's findings and conclusions in its prospectus.

Or the issuer can work with the third party as part of their internal review process and not attribute the findings and conclusions to the third party, nor use the name of the third party for marketing purposes.

If the issuer wants to attribute the findings and conclusions to the third-party reviewer and disclose the party in its marketing materials, then the third party must consent to being named and would be deemed an "expert" under Section 7 of the Securities Act.

Potential Pitfalls & Interim Solutions

Although the objectives of the rating agencies and Dodd-Frank are in sync for the most part, there are some variations in the new rules that could create problems down the road for issuers. Some areas where discrepancies exist:

Varying experience levels of TPR underwriter, QC and project manager.
Clayton solution: Staff to the highest experience level required, for example: three years underwriter experience, five years QC manager experience and seven years project lead/manager experience.

Seasoning requirement timelines.
Clayton solution: Adjust our review to meet varying timelines, for example: 36 months, 18 months or 12 months. We can adjust our due diligence system scope to meet the rating agency requirements, for example: remove origination credit review scope and substitute payment history/collection comments review scope based on seasoning requirements. Regulatory compliance scope can remain on for all loans.

Minimum sample size requirements.
Clayton solution: Perform random sample selections based on required confidence and precision levels as well as assumed error rates. We can also perform random selections to ensure that the minimum sample includes the larger of a required number of loans or percentage of the pool.

Property valuation requirements.
Clayton solution: Our due diligence system can handle the various requirements for reviewing the qualifications of the appraiser and the quality of the origination appraisal. Our system is set up to include any waterfall valuation process (for example: AVM, BPO) and any reconciliation process.

Use of fraud prevention tools requirements.
Clayton solution: Our third-party review process and system can handle the various requirements for verifying the reasonableness of the values found in the origination file for income, employment and occupancy and also for using third-party fraud tools and independent re-verifications.

Review findings reporting requirements.
Clayton solution: Our system captures all data required for ASF Disclosure Package and S&P LEVELS 7.3 data requirements. Those captured data fields can be mapped and delivered in ASF and S&P required formats. Clayton's review findings (exceptions) reports meet various requirements based on the scope of the review, tracking of exception findings (for example: exception was cancelled, satisfied or waived) and initial vs. final loan grading.

Clayton has conferred with leading rating agencies (Moody's Investors Service, S&P, Fitch Ratings and DBRS) to make certain that our securitization-related product meets all of the new requirements for securitizations from each of these agencies.

New More Focused, More Responsive Structure

As we have discussed, the return of non-agency securitization will certainly demand new levels of operational excellence on the part of both issuers and their diligence providers. In anticipation of this higher standard, Clayton has established a new Securitization Group. Senior members of this group have years of experience in due diligence and loan reviews. They are also specialists in compliance, regulations, technology and measurement systems.

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Over the past three years, these executives have been an integral part of the working groups within rating agencies and industry bodies, such as the ASF, that help shape regulatory changes and draft the rules that will implement them.

We expect this group will serve as both a consultative and tactical resource for our clients and Clayton.

Designed along the lines of a SWAT team, it will:

- Consult on the changing landscape of securitization rules and best practices.
- Help develop detailed policies and procedures to implement these new rules.
- Take the lead in performing loan reviews, quality assurance and results-tracking engagements for new RMBS issuance.
- Work with clients on distressed assets and Re-REMIC deals.
- Advise conduits and aggregators on how to anticipate the pre-securitization stage issues.

Similarly, we have continued to make investments in talent and technology in our state of the art operations center in Tampa. For example, we have totally revamped our eClas Compliance platform and have built out an agency-ready, best-in-class data validation, underwriting and reporting system. At the same time, we have upgraded our portfolio surveillance capabilities, adding the new data points that will be required to present ongoing life of asset performance information.

More Data Disclosure Is Coming

Both the SEC and the ASF are calling for issuers and servicers to provide significantly more extensive data disclosure to identify trends and issues at the loan, deal and industry levels. To effectively gauge performance of the loans, all interested parties will need to have access to databases and related workflow and reporting systems equipped to store origination data that is tied directly to monthly performance data at securitization. Further, given the wide scope of data changes required, industry data providers (servicers and trustees) will likely complete data conversions at a different pace requiring database and mapping flexibility to handle changing data scope and format from individual data providers.

Based on our reading of the SEC's proposed rules for Regulation AB, and our ongoing involvement in ASF, servicers may be required to capture the data discussed below and to provide ongoing analysis.

Clayton solution: We currently receive data from more than 50 major servicers and our database collects more than 500 data points. We estimate that this is approximately 44% of the origination data points and 75% of the monthly performance data that is envisioned in the proposed changes to Regulation AB.

The proposed revisions to Regulation AB include language that would require issuers to include pool-level delinquency information in the periodic reports. Clayton's delinquency reporting review and reconciliation would facilitate the issuers' reporting process and provide an extra level of oversight on the data providers' reporting.

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LOAN-LEVEL ANALYSIS

MBSData and New Reporting Tools

InCyt, our dynamic data analysis and reporting platform, provides increased transparency, deeper and more-timely data analysis, and ongoing scrutiny of asset and deal performance. Clients can use InCyt to compare and analyze performance across a portfolio and to compare servicer-level performance across similar pools.

We have also partnered with MBSData LLC to provide accurate and timely deal and loan-level information on public, non-agency mortgage-backed securities. This critical benchmarking and risk-analysis information covers 99% of the active deal universe and is available on a standalone basis or through InCyt.

Deal-level and Vintage Reports

Clayton provides a monthly snapshot of the security performance as well as trending analysis. Information includes the outstanding collateral balance, delinquencies and prepayments for the given month, and information on current and cumulative losses. These reports also provide trending information on conditional prepayment rates, conditional default rates, and overcollateralization for the given deal.

The deal-level reports also include the Watchlist report, which contains details on the riskiest loans identified by Clayton. The Watchlist facilitates the tracking of loan-level and servicer issues through resolution.

Found Money: Real Recoveries from the Default Front

Clayton has resolved 3,221 issues and recovered $44,659,426 across the portfolios it monitored during a recent nine-month period. Clayton's recoveries demonstrate our knowledge of risk factors and industry standards and the strength of our relationships with servicers and master servicers.

Recovery ID 25624

A loss of $1,099,416 was remitted to the trust after a third-party sale. Clayton found that the loss did not contain sale proceeds, despite the property being most recently valued at $670,000. Clayton asked the servicer to confirm the sales price, and the servicer responded that a third-party offer of $610,000 was accepted. Clayton's actions resulted in the remittance of the third-party proceeds of $591,064 to the trust.

Recovery ID 24974

A loss in the amount of $708,884, or 212 percent loss severity, was reported for a loan. The loss amount appeared to be duplicated as the last reported unpaid principal balance was $330,929. Clayton worked with the master servicer to resolve this issue, and subsequently a trailing gain of $354,013 was remitted to the trust in the distribution.

Recovery ID 27134

Clayton identified a loan on which trailing losses of $249,271 and $249,634 passed through to the trust over a consecutive two-month period. Asked to explain the trailing losses, the servicer acknowledged one of the trailing losses was an error and a trailing gain of $249,271 was remitted to the trust.

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Clayton also reviews and reports on portfolios at the vintage level, including servicer performance, foreclosure and REO exposures, loan modifications, losses, mortgage insurance, prepayment penalties, junior liens, and non-recoverable losses reported by the servicers. Trending information is available across shelves and vintages.

Services That You Need Now

Section 943 of Dodd-Frank and its rules and regulations require securitizers in public and private transactions to provide disclosure of fulfilled and unfilled repurchase requests related to breach of representations and warranties.

REPURCHASE REVIEWS

In addition to Dodd-Frank's disclosure requirements, investors and at least one rating agency, Moody's, are calling for more transparency into the repurchase process. Moody's guidance, for example, for new securitizations recommends repurchase monitoring for the first 18 months after issuance.

Our reviews provide summary or loan-level detail of all the repurchase candidates in a security: loans that have been recommended for repurchase or that are pending repurchase, and the outcome of the originator's review of the repurchase demand.

REPS & WARRANTS

Clayton Surveillance services focuses on repurchase candidates that violate representations and warranties of a security. This review does not take the form of a complete re-underwriting review, but rather a pointed identification and review of issues affecting the servicing or cash flow of a loan that may present cause for repurchase. If, however, a re-underwriting review is required, Clayton's Putback team has years of experience re-underwriting loans according to the guidelines in place at origination in order to identify loans that violated underwriting guidelines and as such should be repurchased. The Putback team will review the complete origination file and will submit repurchase claims to the appropriate party.

MORTGAGE INSURANCE REVIEW

Clayton can monitor and review borrower- or lender-paid mortgage and bulk insurance coverage to verify that coverage is maintained, that the necessary claims are filed and paid in a timely manner, that any curtailments are appropriate or supplemental claims are filed, and that the insurance proceeds are remitted to the trust. Clayton works with the servicers and master servicers to resolve any identified issues, including rescissions.

LOAN MODIFICATION REVIEW

Clayton reviews both government-sponsored and proprietary modifications completed by servicers. We verify that modifications completed under government-sponsored programs, such as the Home Affordable Modification Program (HAMP), conform to the stated guidelines (occupancy status, debt-to-income ratio, etc.).

Reports

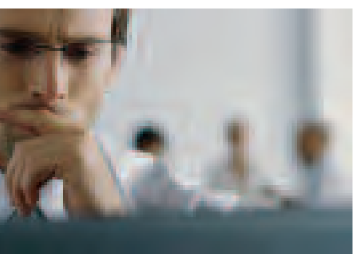
CASH FLOW REVIEW AND RECONCILIATION

Clayton reconciles the cash flow to the bonds each month. The reconciliation process relies on the deal documents and the investor reporting files to recreate the cash flows reported on the remittance statements. Clayton compares its calculations for the principal and interest distribution amounts to the remittance statement. Excess cash is recalculated to review the interest waterfall.

DELINQUENCY REPORTING REVIEW AND RECONCILIATION

Clayton reviews and reconciles servicer and master servicer delinquency reporting on a monthly basis. Clayton utilizes the servicing data, investor reporting, and remittance files to verify the accuracy of the delinquency reporting. Reviews include last interest paid dates; bankruptcy start and end dates; foreclosure start and end dates; and REO start and end dates in its reconciliation process to determine the most accurate delinquency status of a loan.

How to Pick a Partner for the Next Generation of RMBS



The next generation of non-agency securitization will be thoroughly scrutinized and will demand operational excellence—both in pre-issuance due diligence and in ongoing performance surveillance. As the market returns, new "experts" on loan reviews and due diligence will pop up. Some will be start-ups, others small units of large conglomerates. Predictably, all will claim to have the knowledge, expertise and talent to provide these critical services. But will they?

As you do your due diligence on potential TPR and surveillance providers, here are a few questions to consider. Have they played a significant role in the rulemaking? Do they have the senior talent, backed by proven systems? Will they have the capacity to ramp up with the market as it returns, and still maintain quality? Will they have the financial strength to invest in systems and technology? Will they have the wherewithal to stand behind their work?

At Clayton, we are an independent, profitable company focused exclusively on the mortgage and securitization markets. We are ready now for whatever the future brings.

For more information | www.clayton.com