



Methodology

*Third-Party Due Diligence Criteria  
for U.S. RMBS Transactions*

MAY 2011



*Insight beyond the rating.*

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### Related Research:

- Legal Criteria for U.S. Structured Finance Transactions dated September 2009
- Rating U.S. Residential Mortgage-Backed Securities Transactions dated April 2009

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This methodology replaces and supersedes all related prior methodologies. This methodology may be replaced or amended from time to time and, therefore, DBRS recommends that readers consult [www.dbrs.com](http://www.dbrs.com) for the latest version of its methodologies.



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# Third-Party Due Diligence Criteria for U.S. RMBS Transactions

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## TABLE OF CONTENTS

|                                                        |    |
|--------------------------------------------------------|----|
| Overview                                               | 4  |
| Assessment of Third-Party Due Diligence Firms          | 4  |
| Sample Size                                            | 5  |
| Regulatory Compliance Review                           | 6  |
| Credit Review                                          | 7  |
| Data Integrity Check                                   | 7  |
| Property Valuation Analysis                            | 8  |
| Reporting                                              | 9  |
| Appendix A. Sample Size for Due Diligence Error Review | 10 |
| Appendix B. Collateral Deficiencies                    | 12 |



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## Overview

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DBRS is requesting comments on the proposed methodology on third-party due diligence review for U.S. residential mortgage-backed securities (RMBS) transactions. Comments should be received on or before May 16, 2011. Please submit your comments to the following e-mail address: [dbrsdue diligencecomments@dbrs.com](mailto:dbrsdue diligencecomments@dbrs.com). DBRS will publish a final methodology following the review and evaluation of all submissions.

In this report, DBRS outlines its methodology on third-party due diligence review for U.S. residential mortgage-backed securities (RMBS) transactions. The purpose of such review is to assess the accuracy of the data provided to DBRS and to determine whether the mortgage loans were originated in compliance with applicable underwriting standards and legislations. The scope of the due diligence generally includes a comprehensive regulatory compliance and credit review, data integrity check and property valuation analysis.

DBRS expects the due diligence to be conducted by an independent firm (the “firm”) who has no affiliation with any parties to the transaction including the originator, the issuer, the underwriter and the servicer. Furthermore, DBRS believes the underwriting staff should be appropriately trained and have a minimum of two years of industry experience. Additionally, comprehensive quality control procedures, systems capabilities and expertise in the current regulatory environment are necessary for the firm to adequately review a transaction.

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## Assessment of Third-Party Due Diligence Firms

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In an effort to ensure that the third-party due diligence firm is acceptable, DBRS conducts a review to assess the staffing, infrastructure and capabilities of the firm who performs the due diligence. DBRS also requests the firm to attest that the transaction review was conducted without influences from any other party to the transaction. Acceptable firms typically have the following:

- Principals of the firm have significant market experience with appropriate operating processes and staff in place to perform the required tasks.
- Underwriting staff have a minimum of two years of industry experience.
- The firm’s underwriting criteria meet minimum industry standards for determining income, assets, employment and occupancy status.
- The firm has access to legal counsel and/or has the appropriate compliance software in place to accurately interpret state, local and federal regulatory compliance statutes.
- The firm has robust quality control procedures.
- The firm utilizes industry standard anti-fraud software.
- The firm has property valuation software and employs or contracts with property valuation specialists to accurately assess property values.
- The firm has significant systems capabilities and data checking capabilities.
- Disaster recovery procedures are in place and tested regularly.
- Appropriate security measures are in place to ensure compliance with consumer privacy laws.



## Sample Size

Within a pool of RMBS loans, DBRS requests a review of a random<sup>1</sup> sample of individual mortgages to determine whether or not the error rate is less than a critical threshold value that DBRS designates. In principle, this “critical threshold value” may differ based on the error type (regulatory compliance, credit, data integrity, or property valuation) under consideration. The most straightforward approach is to review the documentation for each mortgage loan and count the errors (or exceptions) to find that the error rate (of total errors divided by total number of loans) is or is not less than the threshold value. Since pool sizes can range from less than a hundred to tens of thousands of loans, this direct approach becomes time consuming and expensive for large pool sizes. Hence, we developed a method to specify a reduced sample size to determine when the entire pool is “highly likely” to have an error rate less than the designated threshold.

Appendix A provides a detailed explanation of a statistically meaningful sample and the derivation of such sample size. Generally, DBRS uses a 95% confidence level and a threshold error rate of 5%.

Based on our statistical sampling methodology, DBRS defines a series of suggested sample sizes and the related number of errors allowed for each sample, bounded by a lower and an upper bound. An example of a pool of 500 loans is illustrated below in Table 1. If the due diligence firm chooses an initial sample of 51 loans (the lower bound) and found zero error, then statistically, it can conclude with 95% confidence that the entire pool of loans has an error rate of less than 5%. If one error is discovered, then the sample size needs to increase to the next level of 72 loans (i.e. additional 21 loans). If the total number of error is still one, then a confidence level is achieved. Otherwise, further sampling is needed. Following this logic, we continue increasing the sample size until either a 95% confidence level is achieved, or the number of errors and the sample loans are sufficiently large (the upper bound) to estimate an error rate for the entire pool. Once the upper bound is reached and a higher than threshold error rate is estimated for the pool, DBRS either chooses to not rate the transaction or adjusts loss expectations for the securitized pool.

**Table 1. Sample Sizes for a Pool of 500 Mortgage Loans**

| <b>Confidence Level:</b>                 | <b>95%</b>       |                  |                  |                  |                  |
|------------------------------------------|------------------|------------------|------------------|------------------|------------------|
| <b>Threshold Error Rate for Failure:</b> | <b>5.0%</b>      |                  |                  |                  |                  |
| <b>Pool Size</b>                         | <b>Sample #1</b> | <b>Sample #2</b> | <b>Sample #3</b> | <b>Sample #4</b> | <b>Sample #5</b> |
| 500                                      | 51               | 72               | 135              | 218              | 377              |
| <b>Errors Allowed*</b>                   | 0                | 1                | 4                | 8                | 16               |

\* The number of errors allowed within each respective sample size to statistically conclude with 95% confidence that the entire pool of loans has an error rate of less than 5%.

In practice, the due diligence firm may opt to start the initial sample size at the lower bound, and may stop further sampling once the upper bound is reached. Table 2 below outlines the lower and upper bounds for various sizes of RMBS pools. In the table on the following page, a 5% threshold error rate is used.

1. Given the importance of the randomness of the sample, DBRS studies the sampling technique and confers as necessary with the due diligence firm to ensure random selection.



**Table 2: Lower and Upper Bounds of Sample Sizes (in %)**

**Confidence Level:** 95%  
**Threshold Error Rate for Failure:** 5.0%

| Pool Size | Lower Bound | Upper Bound |
|-----------|-------------|-------------|
| 50        | 28%         | 100%        |
| 100       | 21%         | 100%        |
| 200       | 16%         | 93%         |
| 300       | 13%         | 68%         |
| 400       | 11%         | 53%         |
| 500       | 10%         | 44%         |
| 1,000     | 7%          | 40%         |
| 2,000     | 5%          | 22%         |
| 5,000     | 3%          | 10%         |
| 10,000    | 2%          | 9%          |

Finally, the threshold error rate may vary depending on seasoning, the quality of loan origination and the number of originators in a transaction. Additionally, the sample size may need to be increased to the extent due diligence results were less than satisfactory from previous reviews of the same originator.

## Regulatory Compliance Review

The compliance review is to verify and confirm that each loan in the sample complies with all federal, state and local legislations including, but not limited to, the Truth In Lending Act (TILA), Home Ownership and Equity Protection Act (HOEPA) and Real Estate Settlement Procedures Act (RESPA), as well as any jurisdictional predatory or abusive lending laws.

The due diligence report should detail the loan-level results related to material exceptions, missing documents, regulatory violations, and document any compensating factors.

We use the following guidelines when reviewing the initial due diligence results for a new origination pool:

- If a high cost loan is identified, DBRS does not expect the loan to be part of the securitized pool due to the potentially unlimited liability to the trust and the associated transaction parties. Depending on whether the high cost loan is specific to any originator or state, the sample is expected to be increased to 100% of the applicable loans of the originator or in that state.
- If any material exceptions are found, DBRS expects the loans to be removed from the pool.

For securitizations of seasoned loans (aged more than 18 months), compliance reviews may not be fully conducted due to the absence of certain documents, some of which may have a potential to impede foreclosure sales. As a result, DBRS reviews these exceptions and determines, on a case-by-case basis, the consequences of each category of missing documents. In reviewing seasoned transactions, the guidelines below are typically followed:

- A high cost loan is to be removed and the sample expanded the same way as described above.
- If a high cost test can not be performed due to a missing document, such as the final HUD-1 settlement statement, DBRS either asks that such loans not to be included in the transaction (for loans in states with unlimited assignee liabilities) or increases loss severities (for loans in states with limited assignee liabilities) for the mortgage pool. When increasing severities, DBRS compares the exception



loan to other applicable loans in the same jurisdiction. The magnitude of the loss severity increase depends on how many similar loans have passed or failed the high cost test in the same jurisdiction. For example, if one loan in GA is missing the final HUD-1, but all other GA loans have passed the high cost test, then the penalty in loss severity is minimal.

*Note: Unlimited assignee liability states: IL, IN, KY, MA, NM and NJ.*

- If the absence of certain documents would not impede foreclosure initiations and proceedings or the applicable regulations and legislations have passed their statute of limitation, the loans may remain in the pool.

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## Credit Review

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Credit due diligence may differ based on the seasoning and performance of the mortgage pool. For newly originated loans, we anticipate that the due diligence firm re-underwrites all sample loans to determine if the loans meet the originator's underwriting guidelines, or if not, supply reasonable documentation for any compensating factors. DBRS expects the firm to exercise reasonable judgment during a credit review, particularly with respect to occupancy and documentation verification. Such review should also include verification of documents supporting the borrower's employment, income, assets and occupancy status provided in the application. In addition, the firm should use reasonable judgment and available tools to verify occupancy status, such as comparing the borrower's mailing address in the servicing system to the property address, using fraud prevention tools or LexisNexis to access borrower and property address information.

Loans with any material deviations from the underwriting guidelines or unsupported borrower information are expected to be removed from the pool.

For loans aged between one to 18 months, the lifetime payment history of each sample loan should also be verified.

For transactions of loans seasoned more than 18 months, a re-underwriting and re-verification of origination documents may be omitted. In lieu of such reviews, DBRS requests the following due diligence to be conducted:

- Verification of the lower of 36-month or the life-time payment history,
- Review of servicer notes and collection comments for the current and historical performance of each loan including reasons for default, foreclosures, bankruptcies, forbearance or other repayment plans, or other concerns that could impact the ability of the borrower to make payments on the loan or indications of any property or legal issues,
- Confirmation of terms (note rate, term and balance) and performance of loan modifications

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## Data Integrity Check

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DBRS expects a data integrity check to be conducted by the due diligence firm for both new origination and seasoned pools. For new origination deals, the firm should validate every field in the loan-level data file provided to DBRS, against the actual loan documents.

For seasoned pools, the data integrity check should capture a minimum of the following ten core fields. Except for where it is noted, the validation should be done against the actual loan documents.

- FICO score\* (against the updated FICO)



- Loan-to-value\* (calculated against the updated property valuation)
- Product type (fixed vs. various types of adjustable loans)
- Total debt to income ratio
- Documentation type
- Occupancy status
- Property type
- Loan purpose
- Lien status
- Zip code

\* *No more than 6 months old at the time of securitization settlement.*

The core data fields may be amended on a case-by-case basis depending on the nature of the transaction. For example, a pool of real estate owned (REO) properties does not necessitate a review of borrower information, however, DBRS still expects data integrity checks to be conducted on property-related fields as they may impact the liquidation value of the REOs.

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## Property Valuation Analysis

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All property valuations should be no more than 6 months old at the time of securitization settlement. For a pool of newly originated loans where recent full appraisals are available, DBRS requests these appraisals to be validated, usually through a desktop review, BPO (broker price opinion) or AVM (automated valuation model) on the loan sample. If the resulting value is 10% lower than the appraisal, a second valuation (usually a BPO) is needed to compare against the original appraisal. If the second value still has a greater than 10% variance from the appraisal, DBRS uses the lower value in its credit analysis. In addition, based on the number of loans with negative variance greater than 10%, valuation analysis may need to be expanded from the initial sample size, and loss expectation on the securitized pool may be adjusted.

For seasoned transactions, current property values should be furnished to DBRS. We request updated BPOs (with an assumed marketing period of 90-120 days) to be obtained on the entire sample. Additionally, each loan in the sample should go through a BPO reconciliation review (by a firm other than the one who provided the updated BPOs) that includes, but is not limited to, the relevance of the comparable properties, the exterior condition of the homes and recent market listings and sales records. The reconciliation firm is also expected to provide a retrospective reconciled value that matches the BPO date. If the reconciled value is lower than the updated BPO by greater than 10%, DBRS uses the lower of the updated BPO and the reconciled value for the sample loans.

Furthermore, based on the variance between the BPO values and the initial current property values for the sample loans by geographic regions, DBRS adjusts the property values for the unsampled population accordingly.

Finally, the review should verify that the updated BPO value is no more than 6 months old and that it came from a licensed real estate broker in the jurisdiction where the property is located.



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## Reporting

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DBRS expects to receive a comprehensive loan-level analysis that covers all four areas of regulatory compliance, credit, data integrity and property valuation. In addition, the due diligence company should provide DBRS with a report that includes the scope of the due diligence, the methodology used for selecting the sample, a statement verifying the independence of the analysis (without influence from any transaction parties including the originator, the issuer, the underwriter and the servicer), a description of the loan level scoring system employed by the firm and a summary of the analysis.

The report should be submitted directly from the due diligence firm to DBRS. If an additional review is performed to correct any exceptions or defects, it should be documented in subsequent reports. For example, if a loan was missing a HUD-1 with no other compensating factors in the initial due diligence and was later retrieved and added to the file, this should be noted as a loan missing required documents in the initial report, with a note in a subsequent report indicating the date of recovery of the missing documents.

Based on the final report provided by the firm, DBRS makes appropriate adjustments to the loss expectation of the securitized pool or declines to rate the transaction.



## Appendix A. Sample Size for Due Diligence Error Review

### STATISTICALLY MEANINGFUL SAMPLE

For a pool of  $L$  mortgage loans, we seek the sample size  $S$  ( $0 < S < L$ ) of randomly chosen loans that will expedite the error review and permit us to conclude that the entire pool of  $L$  loans is highly likely to have an error rate less than  $\xi$ . Imagine that the review of the  $S$  loans finds  $n$  errors ( $0 \leq n \leq S$ ). We find that the value of  $S$  that permits the conclusion with confidence level  $\zeta$  that the entire pool has error rate of  $\xi$  or less is given by the solution to

$$v(1+y) - \xi + y^2(v + \xi y) + ky \sqrt{[v + y(v + \xi y)][1 - v - y(v + \xi y)]} / \sqrt{Ly} = 0 \quad (1)$$

We've made the following notation assignments:

$$y = \frac{L-S}{L}; v = \frac{n}{L}; \text{ and } k = \Phi^{-1}(\zeta)$$

where  $\Phi^{-1}(\ )$  stands for the inverse of the standard normal cumulative distribution function.

We determine the sample size  $S$  by solving equation (1) for  $y$  and then applying  $S = L(1 - y)$ . It's not possible to solve (1) analytically, so we apply the numerical technique of bi-section.<sup>2</sup> The table below shows selected results with 95% confidence level and threshold error rate of 5%. As an example in how to read the table, consider the row in which there are ( $L =$ ) 500 total loans. If we review a random sample of ( $S =$ ) 51 loans and find precisely ( $n =$ ) zero errors, then we may stop sampling and conclude with 95% confidence that the entire pool of 500 loans has an error rate less than 5%. If within this first set of 51 loans, however, there are one or more errors, then we make no conclusion. We continue increasing the sample size until either one of the "sample size conditions"<sup>3</sup> is satisfied or we choose to stop sampling with no conclusion.<sup>4</sup>

| Total Number of Loans | Sample Size with n = 0 | Sample Size with n = 1 | Sample Size with n = 4 | Sample Size with n = 8 | Sample Size with n = 16 |
|-----------------------|------------------------|------------------------|------------------------|------------------------|-------------------------|
| 50                    | 14                     | 35                     | 50                     | 50                     | 50                      |
| 100                   | 21                     | 43                     | 95                     | 100                    | 100                     |
| 200                   | 31                     | 53                     | 116                    | 185                    | 200                     |
| 300                   | 38                     | 60                     | 123                    | 205                    | 300                     |
| 400                   | 45                     | 66                     | 129                    | 213                    | 359                     |
| 500                   | 51                     | 72                     | 135                    | 218                    | 377                     |
| 1,000                 | 73                     | 94                     | 156                    | 239                    | 404                     |
| 2,000                 | 104                    | 125                    | 186                    | 268                    | 432                     |
| 5,000                 | 166                    | 186                    | 247                    | 329                    | 492                     |
| 10,000                | 237                    | 257                    | 317                    | 398                    | 560                     |

2. The bi-section method will be efficient and robust since we observe that equation (1) is monotonic in  $y$  for the likely range of error rates.

3. The next "sample size condition" in this example of 500 loans is the finding that there is just one error in a random sample of the first 72 loans. If this condition is satisfied, we stop and conclude with 95% confidence that the entire pool error rate is less than 5%. Similarly, further conditions for larger counted errors are listed in the columns to the right.

4. It is possible that no sampling condition will be satisfied (most likely because the pool error rate really is not less than 5%). We would stop sampling when the number of errors and sampled loans is sufficiently large to permit a standard estimation for the total pool error rate.



## DERIVATION OF THE SAMPLE SIZE

To motivate and explain the development of equation (1), consider the challenge. Before we begin sampling a loan portfolio of size  $L$ , we have no idea what the actual error rate of the pool will be. If we then choose a sample size  $S$  ( $< L$ ) and find a small number of errors, it may not be possible to make a reasonable estimate of total errors (and, hence, error rate for the full pool) due to the small number of observed errors.<sup>5</sup> Ironically, the fewer the observed errors the less able we are to estimate total errors. We find that posing the question of whether we can conclude with given confidence that the total pool error rate is less than a defined critical threshold  $\xi$  permits us to address this “small error” problem.

The threshold error rate  $\xi$  is a DBRS upper bound to what we consider the acceptable error rate for the transaction and collateral type. Hence, if the analysis finds that the actual pool error rate is greater than  $\xi$ , which also means there is no sample size that would permit the conclusion that the actual error rate is less than  $\xi$ , then DBRS either chooses to not rate the transaction or adjusts loss expectation for the securitized pool.

A key element of the derivation of equation (1) is the initial assumption that the pool of  $L$  loans has error rate  $\xi$ . For a sample size  $S$ , we count the number of observed errors  $n$ . This additional information of  $n$  errors in the sample  $S$  permits us to revise the error rate estimate for unsampled loans. As an interim estimate revision for error rate of the remaining unsampled  $L - S$  loans, we take the weighted average of the error rate  $\xi$  and the observed rate  $n/S$ . We then combine this first estimate for error rate of the  $L - S$  loans with the observed errors in the sample  $S$  to determine a uniform estimate  $\hat{p}$  for the entire pool as

$$\hat{p} = \frac{n}{L} + (L - S)[n + \xi(L - S)]/L^2 \quad (2)$$

We assume the error rate in the unsampled collection of  $L - S$  independent loans will be well approximated by a normal distribution with mean value  $\hat{p}$  and standard deviation  $\hat{\sigma}$  of  $\sqrt{\hat{p}(1 - \hat{p})/(L - S)}$ .<sup>6</sup> With  $n$  observed errors in the sample  $S$ , we can conclude that the entire pool of  $L$  loans has fewer than  $\xi L$  errors if

$$n + \hat{p}(L - S) + k\hat{\sigma}(L - S) < \xi L \quad (3)$$

in which  $k$  is defined after equation (1). Equations (2) and (3) give equation (1) with the indicated changes of variable for  $y$  and  $v$ .

5. For example, if we count just 1 error in a sample of 100 loans, the observed error rate for the sample is 1%. But it would not be reasonable to project the error rate for the entire pool of, say, 2000 loans to be this same 1%. There is too much uncertainty in the estimate of 1% error rate with a sample size of only 100 loans.

6. More precisely, in most cases the estimated error rate  $\hat{p}$  is an over-estimate to the true error rate which, for typical parameter values, means the error rate standard deviation  $\hat{\sigma}$  will also be an over-estimate. We begin deliberately with the error rate estimate  $\xi$  in order to be conservative. If, in reality, the true error rate for the pool is greater than  $\xi$ , our treatment would not be conservative. But this is not harmful since the sampled data would not lead us to accept the hypothesis that the pool error rate is less than  $\xi$  for any sample size.



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## Appendix B. Collateral Deficiencies

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Identifying collateral deficiencies is typically not part of a third-party due diligence review. However, some deficiencies may be uncovered in these reviews. In addition to the ones discovered in the third-party due diligence, the custodian of the transaction should identify and report all collateral deficiencies to DBRS as part of the rating process.

Collateral deficiencies are unusual in securitizations of newly originated loans or loans from existing transactions, as custodians and attorneys are often charged with signing off on the completeness of the documentation at the time of securitization. However, for a pool of seasoned mortgages, particularly those that were never previously in a securitization, there were often various deficiencies with respect to the completeness of key mortgage documents, some of which may impede a lender's ability to foreclose on a property. The manner in which collateral deficiencies are handled is a crucial part of our analysis.

In securitizations that DBRS has been asked to rate, we typically see collateral deficiencies related to missing assignments (or intervening assignments), endorsements, mortgages or deeds of trusts, notes and title policies. In some cases, documents may be available, but lack essential terms that can also be considered critical deficiencies. In most cases, however, where an original document is recorded, we have little concern regarding enforceability, as the foreclosing attorney can obtain a certified copy of the original recorded document from the applicable county recorder's office.

Generally, DBRS views the lack of assignments as a greater concern than that of the others. An assignment (and an intervening assignment) is a document that shows the transfer or sale of a mortgage from the original creditor to a third party (and so on). A missing assignment may impair the creditor's standing to foreclose on the property as it fails to demonstrate an unbroken chain of title and therefore to the creditor may have difficulty proving that it lawfully owns the note and the mortgage.

The security instrument, be it a mortgage or a deed of trust, is the official document that describes the lien of the lender on the property, and the rights and duties the borrower and the lender have vis-à-vis one another. The security instrument should always be recorded in order to ensure the lender's lien is perfected and will have priority from subsequent liens on the property. The court in a foreclosure proceeding can take judicial notice of the security instrument, or if the court does not, the creditor can obtain a certified copy of the original document from the county recorder's office, which should suffice as proof of the contents of the original mortgage or deed.

The note and the endorsement are generally not needed to foreclose a property in deed of trust states. The note is the promise to pay from the borrower to the original creditor; the endorsement is the "signing over" of the note to subsequent assignees. In deed of trust states, the exercise of a power of sale under a deed of trust is generally exercisable without the note. However, courts in judicial foreclosure states may require the execution and delivery of the note, and the creditor may have to include a copy of the note with the complaint. Case law in various states has both allowed and denied the ability of a mortgagee by assignment to pursue a foreclosure in the absence of proof that either the mortgagee or its assignor ever had possession of a missing promissory note.

Finally, states generally do not require a title policy to foreclose. However, a foreclosing attorney or other agent will run down title to make certain that every person entitled to notice receives it. Also, the title policy becomes relevant in case the current holder (assignee) of record of the insured mortgage wants to file a claim against the title insurance company with respect to a title defect covered by the policy. If the original policy cannot be located, the closing lawyer or settlement agent might have a copy in their files (or the title insurance agent that issued the original policy should have a record of the policy).



Notwithstanding the above, it is DBRS policy to request substantially all deficiencies to be remedied before securitization settlement. An extension to cure such deficiencies may be granted, for a period of three to six months post closing, with respect to minor deficiencies that will not impede foreclosure sales. On these exceptions, issuers may incorporate mitigating factors such as a cash reserve fund established specifically for collateral deficiencies, particularly for weaker representations and warranties counterparties, in order to facilitate a timely resolution. If the deficiencies are not remedied within the given timeframe, the issuers are obligated to repurchase the loans out of the securitization.

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