

The background of the cover is a photograph of a Gothic-style building with a prominent tower and spires. In the foreground, the suspension bridge structure of the Tower Bridge is visible, partially obscuring the building. The image is overlaid with a semi-transparent grey rectangle containing the title and date. The top of the cover features a blue gradient bar.

Methodology

*Operational Risk Assessment for
European RMBS Servicers*

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Insight beyond the rating.

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Operational Risk Assessment for European RMBS Servicers

TABLE OF CONTENTS

Operational Risk Assessment for European RMBS Servicers	4
Introduction	4
Servicer Review Process	5
Company and Management	5
Financial Condition	5
Loan Administration	6
Customer Service	6
Default Management	6
Investor Reporting	7
Technology	7
Master Servicer	7
Special Servicer	7
Backup Servicer	7
Warm Backup Servicer	7
Hot Backup Servicer	8
Conclusion	8
Appendix I – Sample Operational Risk Agenda for European RMBS Servicers	9



Operational Risk Assessment for European RMBS Servicers

INTRODUCTION

DBRS operational risk assessment procedures for European Residential Mortgage-Backed Securities (RMBS) servicers are designed to evaluate the quality of the parties that service or conduct backup servicing on the loans that are about to be securitised or have previously been securitised in a transaction rated by DBRS. While DBRS does not assign formal ratings to these processes, it does conduct operational risk reviews to determine if a servicer is acceptable and incorporates the results of the review into the rating process for new transactions and into the surveillance process for outstanding transactions to be rated by DBRS. It should be noted that DBRS recognises that there are different rules, regulations and practices for each jurisdiction in Europe and as such tailors its approach as applicable.

DBRS begins the initial servicer review process by scheduling a date to conduct an on-site visit of the company. Once a date is confirmed, DBRS sends a sample agenda that outlines the topics to be covered during the meeting which includes a list of documents to be provided such as organisational charts, financial statements and performance statistics (Appendix I). During the on-site review, DBRS meets with senior management and, if deemed necessary, operational staff to discuss the servicing operations, tour the facilities and review system demonstrations, as appropriate. The on-site review typically takes one to two days, depending on the product(s) being serviced and number of servicing sites. DBRS assesses the information gathered through the review process, along with its surveillance data and industry statistics to determine if a servicer is acceptable. In instances where DBRS determines that the servicer is below average, issuers may incorporate certain structural enhancements into a proposed transaction such as additional credit support, dynamic triggers or the presence of a warm or hot backup servicer in order for DBRS to be able to rate the transaction.

DBRS conducts periodic reviews of the servicer as part of the ongoing monitoring of outstanding transactions or in cases when unexpected events warrant such as the sale of the operation, a material change in ownership or a bankruptcy of the servicer. The reviews are intended to inform DBRS of any changes that have taken place since the last operational risk review, especially highlight any material changes to the operation or its management. The review may be accomplished through a conference call, meeting with senior management or by an on-site visit to the servicer. The type of review needed is typically determined based on the length of time since the last on-site review, the performance of the rated transactions and the materiality of any changes within the organisation. Any findings from the update review are incorporated into the surveillance process in addition to being included in the analysis for new transactions.

In cases when the servicer or its parent is rated or internally assessed by DBRS at below investment grade or if DBRS believes that, while not imminent, there is a risk that the servicing may need to be transferred at a future date, issuers may incorporate a warm backup servicer as a transaction party. Some reasons for the inclusion of a warm backup servicer could be: the company is up for sale, senior management recently departed, lines of credit were not renewed or now have more restrictive covenants, or delinquency levels are trending upward and there is concern about potentially hitting servicing transfer triggers in a transaction. Certain reasons for the inclusion of a hot backup servicer could be: if a servicer is relatively new to the servicing business, lacks experience servicing the product being securitised, has fewer than 10,000 loans in its portfolio or the servicer or its parent is a below investment grade rated entity. In the event that DBRS determines that a servicer is unacceptable, it may refuse to rate the deal.



SERVICER REVIEW PROCESS

1. The servicer review process typically involves an analysis of the following:
2. Company and Management
3. Financial Condition
4. Loan Administration
5. Customer Service
6. Default Management
 - Collections
 - Loss Mitigation
 - Bankruptcy
 - Foreclosure
 - Real Estate Owned (REO)
 - Advancing
7. Investor Reporting
8. Technology

For secured non performing loan portfolios , the process focuses on the company's strategy for handling various types of delinquent loans and its success rate in getting those loans to re-perform and maintain performance, and if this is not possible how efficiently and loans are processed through the foreclosure process.

COMPANY AND MANAGEMENT

DBRS believes that no servicing operation can be successful without a strong, seasoned management team that possesses demonstrated expertise in the product(s) they are servicing. As a result, DBRS views favourably those servicers whose management team possesses greater than ten years of specific industry experience. Furthermore, adequate capacity and resources to handle fluctuations in loan volume are of paramount importance.

DBRS also believes internal assessments and quality-control reviews are critical in recognising procedural errors that may not be easily detectable. These reviews can be used to identify trends, training opportunities and exception practices. Frequent checks can assist management in quickly instituting changes to areas needing improvement, as well as benchmarking those results to performance. In addition to the aforementioned reviews, a monitoring process should be in place to ensure that the servicer is in compliance with all applicable laws, rules and regulations and that all employees in borrower-facing positions are appropriately trained.

FINANCIAL CONDITION

DBRS reviews the servicer's financial condition to determine whether the servicer has sufficient resources and to assess the likelihood of a servicing transfer, servicer bankruptcy or other potential interruption in cash flow to a transaction such as the servicer's ability to make advances.

In cases where DBRS does not maintain a public rating of the entity performing a servicing role, the DBRS Financial Institutions Group provides an internal assessment (IA) of the relevant institution. The IA is monitored over the life of the transaction and DBRS will notify the relevant institution if the internal assessment is changed. In certain cases, DBRS may rely on public ratings assigned and monitored by other credit rating agencies.

Some items that are reviewed as part of this process may include:

- Company ownership structure
- Management experience
- Corporate rating of any parent company (if applicable)
- Internal and external audit results



- Revenue sources including servicing fees and lines of credit
- Costs to service
- Litigation (past, present and expected)
- Existing business strategy and strategic initiatives
- Recent or planned mergers or acquisitions
- Recent or planned transfer of servicing rights
- Securitisation history and future plans

Any financial stress identified can elicit servicing problems either immediately, as in the case of a servicer bankruptcy, or lead to a slow degradation of the performance of the collateral. Therefore, the servicer's financial condition weighs on all aspects of DBRS analysis of RMBS transactions including the evaluation of proposed credit enhancement levels and the presence of proposed minimum structural safeguards.

LOAN ADMINISTRATION

DBRS reviews the loan administration area to assess servicer's loan booking accuracy, data integrity, application of payments to borrower accounts and exception rates. Servicers with large numbers of un-reconciled items indicate a fundamental problem with the cash management operation. As a result, DBRS views favourably those servicers with a high level of automation and a low tolerance for un-applied funds. Additionally, DBRS reviews the servicer's efforts towards compliance with regulatory guidelines and industry best practices. Furthermore, the servicer's portfolio is reviewed for changes in size, product type or delinquency to determine if more frequent reviews or management calls might be necessary to monitor the performance of the portfolio.

CUSTOMER SERVICE

DBRS reviews the customer service area to see how well the servicer responds to borrower inquiries. Performance metrics such as call hold times and abandonment rates are reviewed to determine if the department is appropriately staffed or if certain call blockage features are in place to prevent borrowers from being able to speak to a representative. Furthermore, a monitoring process should be in place to ensure that the servicer is in compliance with all applicable laws, rules and regulations and that all employees in borrower-facing positions are appropriately trained.

DEFAULT MANAGEMENT

The effectiveness of a servicer's operation has a direct impact on security performance and ultimately losses to the RMBS investor. A servicer's strategy for handling loans in default as well as its ability to closely manage loans in foreclosure and bankruptcy can stabilise or improve pool performance. The marketing of repossessed properties, as well as ultimate foreclosure to sale timelines and cost containment, can also indicate a servicer's capabilities, particularly as many already carry a large number of repossessed properties on their books.

A limited number of servicers use predictive dialer systems that incorporate behavioral scores to identify and prioritise the riskiest borrowers. Collection efforts generally escalate in intensity as accounts roll to more advanced delinquency categories. Depending on the stage of delinquency, the servicer may offer a forbearance or modification plan that can include a reduced interest rate, capitalisation of monies owed or debt forgiveness, in addition to a formal payment schedule, to help the account become current. In instances where a borrower acknowledges that he or she cannot afford to remain in the home, the servicer often uses a short sale as an alternative to the foreclosure process. In this instance, the borrower agrees to sell the home for an amount less than the full payoff on the loan and is released from the lien. DBRS believes that the use of strategies such as capitalisation of arrears, short selling and restructuring of the loan terms to improve affordability can be successful strategies that may ultimately serve to reduce losses, however, their implementation and use requires suitable control. DBRS reviews approval requirements for such strategies and success rate in order to determine the ultimate effectiveness of the decision making process.



DBRS views favorably those servicers that have predictable performance and strong monitoring procedures for delinquent accounts. Once an account becomes delinquent, effective collection procedures can minimise losses to investors. Accordingly, DBRS evaluates the quality of the collections strategy and staff in order to determine their success rates in contacting borrowers and determining their ability and willingness to pay.

INVESTOR REPORTING

DBRS reviews the investor reporting function to see if they have a track record of timely and accurate remittances to trustees and/or master servicers. Consequently, DBRS views favorably those servicers who have never had to restate a remittance report.

TECHNOLOGY

Technology resources are an integral component of the servicer review process. While DBRS does not opine on the relative merits of specific systems architecture, adequate systems controls, consumer privacy protection and backup procedures, including disaster recovery and business continuity plans, are considered critical processes. Furthermore, DBRS reviews back up arrangements, especially for any offshore suppliers to gain comfort that there is a backup plan in place to ensure minimal downtime. Over the past few years, leveraging the Internet has enabled many firms to operate effectively in the mortgage business. Servicers have used the Internet for marketing, borrower service and the dissemination of pertinent information, such as payment reminders or inquiries relating to refinances, modifications or payoffs. As a result, DBRS expects servicers to have the appropriate staff and controls in place to ensure website availability, account maintenance and enhancements. Sophisticated technology, with robust functionality, is viewed favorably by DBRS as it often helps bring large efficiencies to the servicing operations in addition to more predictability in terms of loan performance.

MASTER SERVICER

Master servicers do exist in European RMBS but are relatively uncommon. A master servicer is responsible for collecting loan data from primary servicers, calculating the expected principal and interest payments that should be remitted and reconciling any differences with the servicers. A master servicer is also responsible for making principal and interest advances in the event the primary servicer fails to do so. As a result, financial condition is of utmost importance when evaluating a master servicer. Additionally, master servicers need to report and remit funds timely and accurately to the trustee.

SPECIAL SERVICER

The special servicer is tasked with returning delinquent loans to a performing status or quickly disposing of loans that are non-performing. As a result, DBRS places particular emphasis on the years of experience and default management expertise of the special servicers. The point at which special servicing moves from primary servicing to special servicing is not standard in Europe. The process depends on the jurisdiction and the capabilities of the primary servicer. Of significant importance is the ability of the servicer to manage delinquency roll rates, offer effective workouts and minimise redefault rates. DBRS views favorably those servicers that employ sophisticated decision-making software to facilitate and track the loss mitigation process. Furthermore, a special servicer's ability to quickly liquidate REO properties at acceptable loss severities is paramount.

BACKUP SERVICER

While there are no consistent definitions of warm and hot back up servicer arrangements in Europe, DBRS generally defines the two as follows:

WARM BACKUP SERVICER

A warm backup servicer is responsible for performing all of the activities necessary to ensure that in the event of a default or bankruptcy of the current servicer it would be able to take over all of the primary servicing responsibilities outlined in the servicing agreement within a short period of time (typically 30-120



days). In an effort to prepare for the transfer, the warm backup servicer typically conducts an on-site visit of the company, maps all of the data fields to their servicing system and receives monthly data tapes of the transactions to ensure minimal downtime.

HOT BACKUP SERVICER

A hot backup servicer is responsible for performing all of the activities necessary to ensure that in the event of a default or bankruptcy of the current servicer it would be able to immediately take over all of the primary servicing responsibilities outlined in the servicing agreement. In an effort to prepare for the transfer, the hot backup servicer typically conducts an on-site visit of the company, maps all of the data fields to their servicing system and receives daily/monthly data tapes of the transactions to ensure minimal downtime. The hot backup servicer is also responsible for tying out with the servicer on all remittance/investor reports to ensure they are accurate in addition to monitoring the ongoing performance of the servicer.

CONCLUSION

DBRS recognises that servicer performance is a key component in rating RMBS transactions and conducting appropriate surveillance. As a result, DBRS continues to refine and adjust its operational risk assessment procedures for European servicers, as necessary, in an effort to incorporate any changes or issues that arise in the marketplace. As noted above, DBRS does not assign formal ratings to these processes; however, it does consider the results of its reviews as part of the rating and surveillance processes.



Appendix I – Sample Operational Risk Agenda for EURO-PEAN RMBS Servicers

Company and Management

- Company history, ownership and operating experience.
- Financial condition/profitability.
- Management experience.
- Staffing, training and retention rates.
- Portfolio size and composition.
- Strategic initiatives.
- Litigation (past, present and expected).
- Cause of servicer removal from any previous transaction.
- Recent or planned mergers or acquisitions.
- Recent or planned transfer of servicing (rights), if any.
- Runoff rates.
- Internal and external audit results.
- Efforts to ensure regulatory compliance
- Have you ever been or are you now the subject of any regulatory action? If so, discuss any findings.
- Securitisation history and future plans.

Loan Administration

- New loan boarding process.
- Procedures for boarding accuracy and data integrity.
- Reset notification.
- Cash management procedures and controls
- Payment processing and controls.
- Exception and suspense management.
- Account reconciliation and timing.
- Post-closing quality reviews.

Customer Service

- Procedures for responding to borrower inquiries.
- Strategy and technology.
- Call volume and average time to answer.
- Number of representatives and ratio to call volume.
- Level of call blockage, if any.
- Response times for inquiries.

Collections

- Collection strategies for early-, middle- and late-stage collections.
- Explanation of call and notice cycles by product type.
- Account-to-collector ratio.
- Borrower contact rates
- Hold time and abandonment rates.
- Use of credit and behavioral scoring and other technology.
- Policies regarding modifications, forbearance and deferrals.
- Delinquency, roll and cure rates.
- Property inspections and current property valuation procedures.
- Eviction procedures.
- Charge-off process.
- Use of technology.



Loss Mitigation

- Significant changes (past or planned) in procedures or emphasis regarding workout strategies or timelines.
- Repayment plan, modification and forbearance plan procedures.
- Re-default rates.
- Procedures and timelines for property evaluation (condition and value).
- Approach to fraud detection.
- Use and monitoring of forbearance strategies,.

Bankruptcy

- Bankruptcy procedures and technology.
- Percentage of loans performing under the bankruptcy plan.

Foreclosure and Sale

- Foreclosure process and initiation.
- Property preservation/maintenance and valuation.
- Property evaluation, maintenance, repairs and inspections.
- Percent of foreclosure sold through a third party.
- Number and dollar amount of loans in portfolio.
- Eviction processes.
- Broker selection and pricing strategy.
- Property evaluation (condition and value).
- Property management.
- Liquidation methods and marketing plan and strategy for disposition (e.g., auctions, renting, etc.).
- Insurance-claims processing.
- Filing of borrower judgments.
- Recovery rates.

Investor Reporting

- Procedures for dissemination of reports to investors and trustees.
- Average number of investors remitted to on a monthly basis (last 12 months).
- Average dollar of monthly remittances (last 12 months).
- Number of late remittances in the last 12 months.
- Are accounts commingled? If so, how long?

Technology

- Core servicing system strengths and weaknesses.
- Capacity remaining in the servicing system.
- Web site availability, usage and security.
- Procedures for vendor selection and oversight.
- Disaster recovery/business continuity plans and success of last test.
- Frequency of full-system backup.
- Future initiatives.

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