

U.S. Structured Finance Newsletter

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DUE DILIGENCE SERVICES INCREASE IN THE SECONDARY MORTGAGE MARKET

As the industry prepares to address the deterioration in the subprime mortgage market, investors have become more cautious about investing in RMBS transactions. Consequently, there has been an increased demand for the services provided by due diligence and surveillance firms.

Services provided by third-party due diligence and surveillance firms can be customized based on the transaction and may include any or all of the following options: completely re-underwriting a loan, pulling credit bureau scores, obtaining new appraisals, monitoring monthly remittance reports and reviewing the loans for fraud or regulatory violations. Due diligence reviews are typically done on site at a seller's location but can also be completed by using imaged or shipped files. Most of the principals of these firms have significant industry experience; however, the underwriting staff are typically not employees of the company but are instead sourced from a pool of available underwriters within the industry.

In the past, investors would hire third-party due diligence vendors to re-underwrite a sample of loans (usually 10% to 25%) in order to ensure that the loans were originated in accordance with the seller's underwriting guidelines (both from a credit and compliance perspective). The due diligence reviews were typically conducted prior to transaction closing. However, with the recent rise in subprime delinquencies, market participants are increasingly using due diligence services after closing to help identify loans with representation and warranty (rep and warrant) violations so that investors can "put back" delinquent or fraudulent loans to sellers. In addition, the practice of hiring third-party surveillance firms to monitor servicer and trustee performance on transactions is also increasing as investors look for additional ways to ensure that their interests are being properly administered.

It should be noted that even though almost all of the transactions in the secondary market have had some level of due diligence conducted on the loans, the results of these audits are not always disclosed to rating agencies or investors. DBRS believes that this practice may change going forward as the industry requires more information to better assess the risks inherent in these transactions. DBRS also believes that sample sizes and reject rates are likely to increase as a result of the current market conditions. In the past, loans that were coded as high risk by due diligence firms may have been included in transactions. Going forward, however, this practice will likely change based on heightened market concerns. DBRS believes that due diligence and surveillance firms provide an invaluable service to the industry because of their independent nature. As a result, DBRS will continue to monitor the third-party services available to the industry as investors and market participants endeavor to improve their risk-assessment processes in the future.

DBRS recently published a report summarizing the due diligence services available to the mortgage market along with many of the firms that provide these services. For further details, please see the commentary *Review Services for the Secondary Mortgage Market* at www.dbrs.com.

For questions or comments, please contact Kathleen Tillwitz at ktillwitz@dbrs.com.