

Fitch
One State Street Plaza
New York, NY 10004
(212) 908-0810
www.fitchratings.com

Fitch: Seller/Servicer Risk Trumps Trustee's Role In U.S. ABS Transactions

Fitch Ratings-NY-February 24, 2003: While the default rate for U.S. asset-backed securities (ABS) transactions remains low relative to comparably rated corporate securities, in the last few years there has been a noticeable increase in ABS related performance problems, particularly in transactions involving thinly capitalized seller/servicers and unique asset classes. Recently, ABS trustees have come under fire from some in the market who have suggested that performance issues for certain ABS transactions reflect failures by the trustees. Fitch Ratings believes this misses the mark. While the trustee can play an important role in an ABS deal, Fitch believes that unrealistic reliance on trustees increases the risk to investors by potentially masking other more important considerations when evaluating structured finance investments.

Specifically, Fitch believes it is important to consider the critical role played by the seller/servicer in ABS transactions, which is heavily dependent on the stability of their business model and their financial viability. In addition, cash flow stresses should include appropriate servicing fee scenarios, and post-closing transaction performance and servicer financial health should be followed closely. Focusing of these key areas, in Fitch's view, is a more effective way for ABS investors to mitigate risk than any dramatic change in the trustee's role might provide.

Fitch recognizes that a trustee can play a valuable role in ABS transactions, including cash flow management and, in some cases, proactive workout resolution. It is also likely that in some specific situations, the trustee's performance was substandard and needs to be addressed. At the same time, these issues should not come as a surprise. The trustee's role in ABS transactions has clearly been marginalized over time due to a combination of fear of

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liability and low fees. There are some steps that can be considered that could improve trustee performance, including fee increases and modifications to the transaction structures in which trustees explicitly assume key responsibilities for the benefit of investors. Fitch will continue to work with trustees and investors to improve trustee performance and accountability. (See Fitch report 'Reviewing Structured Finance Trustees', dated June 7, 2001 and available on the Fitch Ratings web site at 'www.fitchratings.com'). That said, even these changes would do little to address the more fundamental problem of entities and/or assets that may be poor candidates for securitization, as well as structural weaknesses in the event of a servicing disruption.

Discounting transactions in which there are substantial allegations of fraud (such as NCFE), Fitch believes one of the principal reasons for the recent credit problems is the heightened liquidity risk in today's environment, particularly for more thinly capitalized companies with limited funding flexibility. The harsher liquidity environment leads to even greater pressure on thinly capitalized seller/servicers. In addition, over the past several years a variety of less homogenous (off-the-run) assets have been securitized for which the number of available and willing substitute servicers can be limited. With off-the-run assets, or the use of non-standard servicing systems, the financial viability of the seller/servicer becomes a particularly important issue because of the potential difficulty of accomplishing a timely and efficient transfer of servicing in the event of the financial failure or other default of the seller/servicer.

The convergence of these events requires the U.S. ABS market to more closely understand the roles of seller/servicers in ABS transactions. As liquidity has become more rationed and substitute servicing options less available, original stress assumptions and expectations for smooth servicing transfers are being called into question.

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In order to determine the likelihood and feasibility of a servicing transfer, appropriate analysis of the servicer's business platform, financial health and operational quality is critical. This coordinated review may make it possible to identify weaknesses that can be mitigated through additional credit enhancement, legal and structural revisions and improvements to back-up servicing arrangements. Ultimately, this type of review may result in a 'rating cap' or the identification of transactions that are ratable only at ratings below investment grade because of the high potential for near-term performance interruptions.

As part of the initial transaction review, it has become increasingly important to consider servicing fees and the potential impact of servicing disruptions in cash flow stresses. The amount of the servicing fee, the way in which it is structured, and its placement in the waterfall should be reviewed closely. While it is a fact that even financially stable seller/servicers may experience credit deterioration, it is more likely that a financially weak servicer will default or trip a performance trigger at some point in the life of a transaction leading to a servicing transfer. For weaker seller/servicers and for certain asset types, it is particularly important to test transaction cash flows with the servicing fee at a level appropriate for the collateral pool, assuming a distressed scenario and with the servicing fee in a senior position in the waterfall.

Active performance analytics, the act of monitoring the transaction's and servicer's performance, can be another important mitigator of risk. Fitch recognizes that there is a high correlation between servicer financial health and transaction deterioration. In some cases, performance related downgrades may be amplified by simultaneous deterioration in a servicer's financial wherewithal. A servicer in poor financial condition may be unable to adequately support the servicing operations, leading to higher delinquencies and losses. Recognition of this fact

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may provide early warning signals that allow investors to intervene proactively to protect their interests.

Fitch's increased focus on seller/servicer related risks on new transactions has led to higher credit enhancement levels, additional structural protections and more explicit back-up servicer arrangements in a number of transactions. More importantly, these same issues have resulted in rating caps on certain deals and in several cases, Fitch's election not to rate the transaction at all. On a post closing basis, the evidence of these risks has amplified certain performance related rating actions and will continue to influence Fitch's rating actions to a higher degree going forward.

Contact: Kevin Duignan 1-212 908-0630 (ABS) or Roger Merritt 1-212-908-0636 (Credit Policy), New York.

Media Relations: James Jockle 1-212-908-0547, New York.