

## Structured Finance Market Opinion Survey Confirms Operational Risk Remains A Serious Concern For Securitization Professionals

The majority of securitization professionals cite operational risk as a leading concern in structured finance transactions, trailing only traditional credit risk as the overriding factor potentially affecting a deal's health, according to the results of Standard & Poor's Ratings Services' recent Structured Finance Market Opinion study.

The survey solicited views from market participants on how to best define, measure, monitor, report, and mitigate operational risk in securitized transactions. More than two-thirds of respondents chose operational risk as one of the top-three most important areas of risk in the market, surpassing other highly touted forms of exposure, such as legal (40%), modeling (39%), interest rate (27%), regulatory (24%), and correlation risk (9%) by a sizable margin. In fact, only credit risk received more votes, with 79% of market players choosing it as one of the most significant factors.

Furthermore, a majority of respondents (78%) identified servicer quality as the most critical element of a transaction's operational risk profile, followed by transaction structure. The inherent serviceability of a particular receivable was in third place, followed closely by deal administration, which includes the work of the trustee and the general level of a transaction's disclosure.

"The single biggest mitigant to operational risk for securitized transactions is an experienced servicer in the relevant asset class," said one respondent. "There is a need to focus more specifically on internal controls," commented another, "including the amount of resources dedicated to servicing the securitization and management's involvement in and understanding of the securitization structure and obligations."

Another participant noted: "It all comes down to understanding your collateral. The further down the credit spectrum the obligor, the higher the need for hands-on servicing."

Moreover, when asked which asset characteristics are most essential in determining the operational risk profile of a transaction, nearly 60% said that specialized obligors or industries deserve more scrutiny, while prime vs. subprime obligor credit quality was chosen as the second most salient factor. The third most critical determinant was whether a transaction involved secured or unsecured receivables, according to survey results. "These responses from market players may demonstrate that while the underlying credit quality of the borrower is still a very important factor, recent defaults and unexpected stress for transactions containing more niche collateral, such as manufactured housing,

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franchise loans, and health care receivables, as opposed to mortgages and credit cards, may be redirecting investor focus onto the type of industry for which collateral is being securitized,” said Michael Gutierrez, a director and head of Standard & Poor’s Structured Finance Servicer Evaluations Group.

Not surprisingly, a majority of respondents (71%) chose a company’s corporate liquidity and cash flow generation as the most critical operational/financial indicator of seller/servicer risk, followed by a company’s funding diversity and flexibility (59%), and the breadth/capacity of a company’s servicing platform (58%).

“I believe that criteria should be developed to link corporate financial cash flow and liquidity to the securitization rating,” suggested one respondent. “Most, but not all of the big disasters in ABS have occurred when the sponsoring corporation had weak cash flow or no other sources of liquidity and put itself (and investors) in a position of moral hazard, ranging from weak servicer performance to fraud.”

### **Operational Risk Profile Focuses On Servicing, Transaction Structure, And Asset Class**

In response to a rising chorus of questions and concerns about noncredit risk factors being voiced at various industry conferences and media outlets throughout the year, Standard & Poor’s Structured Finance recently commissioned the fourth edition of its “SF Market Opinion” global survey to determine the views and perceptions of securitization professionals regarding operational risk.

A total of 197 participants, all of whom were familiar with operational risk in structured finance, completed the survey. Of these, 28% identified themselves as investors, 26% as investment bankers, 20% as issuers, and the remainder represented a mix of other roles in the structured marketplace.

SF Market Opinion is a recurring study covering hot topics pertinent to the structured finance community. It is intended to create valuable discourse and give securitization professionals an opportunity to hear what their peers are saying on critical issues.

Operational risk management and compliance in the capital markets has become one of the prime focuses of regulatory measures in recent years. From Basel II to Sarbanes-Oxley to the SEC’s recent “Interagency Statement on Complex Structured Finance Activities,” the oversight of operational issues related to fixed-income transactions—internal controls, corporate governance, risk of fraud, timeliness of processes, the failure of information technology systems, legal risk, and the risk of failed execution, delivery and process management, just to name a few concerns—has come to the fore.

In the context of the securitization markets, specifically, operational risks typically fall into three buckets:

- Seller/Servicer issues
- Transaction structure/legal issues
- Asset class issues

Seller/servicer risks may involve questions such as:

- How easy is it to smoothly transfer servicing?
- What are the quality, depth, and breadth of a company’s servicing platform?
- How efficiently are those systems running, and how well are they being monitored?
- How robust is a seller’s corporate liquidity, cash flow generation, and funding diversity?
- What is the size of the company? The ownership structure?

Transactional and structural concerns include:

- Is the Special Purpose Entity separate enough from the seller? What is the level of tieback to the corporate entity?
- Does the deal represent a true sale of assets, or is there a greater risk of the sale being recharacterized as a financing or secured loan?
- Is there perfection of security interests to dis-incent other creditors from attacking the structure?

- How much latitude does a seller/servicer have in determining important calculations, such as when to charge-off receivables, how much can be advanced to an obligor or amounts remitted to trust accounts?

Asset-specific characteristics are another determinant of a transaction's operational risk profile. Concerns about these characteristics include:

- What is the inherent serviceability of a particular asset?
- Is it an amortizing or revolving receivable?
- Is it a specialized obligor or industry?
- Prime vs. subprime obligors? Secured vs. unsecured receivables?

Operational risk management is no longer just a theoretical issue for the securitization industry. Given the heightened regulatory scrutiny of operational processes in structured transactions proposed by Regulation AB and the "Interagency Statement on Sound Practices Concerning Complex Structured Finance Activities" (and the growing importance of risk management systems overall in ABS and MBS in light of several market blow ups during the last five years), Standard & Poor's Structured Finance group thought it useful for market participants to voice and share their views on how to monitor, measure, and mitigate most effectively all relevant operational risks related to a securitization.

According to the results of SF Market Opinion, respondents generally suggested increased or tighter reporting standards and controls as a primary mitigant to operational risks, including "third-party audits of operations," according to one participant. "This includes accounting, workflow/segregation of duties, testing of Management of Information Security back to source documentation, as well as the monitoring of exceptions, consumer complaints, and investor complaints and inquiry. Sound underwriting and consistent, quality servicing are key to any structured finance deal."

The market players added that a need exists for robust stress testing and for a measure of the impact on performance (that is, in the form of delinquencies, defaults, loss, and yields) because of changes in underwriting, interest rates or credit spreads, or other economic factors affecting the underlying collateral, such as unemployment, consumer bankruptcy, and vacancy.

Another respondent suggested, "The market needs to establish a metric that addresses the important aspects of operational risk, in order to compare transactions."

### **"Skin In The Game": Seller/Servicer Accountability**

Given the intense focus on servicing during the past 18 months within the industry, perhaps it is not surprising that more than three-fourths of the respondents identified servicer quality as the most critical element of a transaction's operational risk profile.

"Revolving deals must have a way of monitoring any significant changes in underwriting or servicing policies, procedures, and guidelines, such as prior notice and approval, or a ban on any such changes," said one participant. "Smaller servicers, which are more likely to be at risk in times of financial or market stress, must be monitored more closely, as they are more likely to play fast and loose with servicing and reporting to maintain cash flow."

"There also needs to be a better method of determining whether a servicer is properly charging off delinquent accounts," said another respondent.

The ease and feasibility of servicing transfers seemed to be on the minds of several participants as well. Many suggested that those who oversee transactions should have a specific plan prepared for such an event, with details figured out beforehand as to whom the servicing would be transferred to, the timing, the costs involved, and who bears those costs.

One aspect of this that should be scrutinized more, according to market players, is whether servicing operations are centralized or decentralized. "Operations in which collections are decentralized in store locations are very difficult

situations when servicing transfer is necessary,” said one professional, most likely referring to the troubled servicing procedures characterizing the Heilig-Meyers imbroglio of a few years back.

Another market participant wrote that “skin in the game,” or vested interest in the successful performance of a transaction, is another effective mitigant to operational risk. “If the seller/servicer stands to lose money through poor asset performance, operations are more likely to remain sound. If the issuer or seller/servicer has cashed out through securitization and has no vested interest in asset performance, operational risk increases.”

A recurring theme in the open-ended comments was the need for servicers and trustees who are experienced with particular asset classes, or those that have a demonstrated ability with new asset classes.

Continuing in this vein, some survey participants encouraged more of a focus on the physical assets underlying a transaction, suggesting that the staff reviewing these assets should have specific expertise and be familiar with evolving agency regulations and private regulations as they change. “The ongoing servicing of the assets is also affected by how efficient and organized the custodians are in responding to the servicer’s request for release and filing trailing documents,” commented one person.

Overall, respondents seemed to be in favor of better financial disclosure of servicers, including more frequent, in-depth due diligence of these companies from a third-party source. “Experts should audit the collectors’ notes on a securitizer’s servicing system to ensure compliance with guidelines and deal documents,” noted one survey participant. “They should also perform audits of private companies with respect to their financial statements to track the creditworthiness of servicers.”

The SF Market Opinion respondents also reported that, as expected, they view a company’s corporate liquidity and cash flow generation as the most important operational/financial aspect of a seller/servicer (71%). A company’s funding diversity and flexibility was second most important to respondents, garnering 58% of the vote. Interestingly, in a tie for second, 58% of participants chose breadth of a company’s servicing shop as the most critical factor.

“This indicates a sharp turnaround from prior years in which a seller/servicer’s financial strength was seen as the paramount factor affecting seller/servicer risk,” said Mr. Gutierrez. In other words, it is possible for a well-funded company to have a flawed servicing operation these days. “Recent industry events, such as the highly publicized regulatory and compliance issues affecting Fairbanks Capital Corp., which had nothing to do with the favorable financial strength of its corporate parents—yet ended up adversely affecting its servicing capabilities—may be a factor in this change.”

Debt rating and servicer ranking (if applicable) were virtually tied (44%) as the fourth most important operational aspects of a seller/servicer, according to survey respondents.

### **Deal Mechanics, Structure, And Shifting Of Risk Are Problematic As Well**

After servicer quality, participants identified transaction structure as the second most critical element of a transaction’s operational risk profile, with almost 54% of total participants voting for it.

It is not surprising that the inherent asset serviceability of a particular receivable was in third place (43%, virtually tied with the quality of a transaction’s deal administration), as each asset class has its own unique structural characteristics and performance profile. The perfection of security interests in the underlying assets (which can bolster the true-sale/nonconsolidation argument) took the number four slot, garnering 38% of the vote. Fewer participants chose other structural components as essential components of an operational profile: servicer advance mechanisms (26% of total respondents), asset substitution rights (22%), and whether a deal write-off policy was firm or flimsy (21%).

However, one respondent suggests that the industry must find some method to help investors understand and compare different Pooling & Servicing Agreements, “because these can be fairly opaque,” the securitization player remarked. “Different parties’ motivations under different cash flow scenarios can be hard to divine. From our manufactured housing experience, we have learned that subtle cash flow trapping mechanisms can be interpreted differently at different times by different parties, with occasionally unpredictable effects on the cash flows.”

Added another, “There should be a mechanism or rating associated with how the cash in a transaction is handled, i.e., is there a lockbox, or do insurance and taxes flow through the trustee straight to the providers, or does it have to go through the company?”

Other SF Market Opinion respondents called attention to deal mechanics and the shifting of risk within the waterfall structure as potentially problematic operational issues deserving more scrutiny.

Certain transaction structures, for instance, particularly those in the home equity loan sector, are allowing funds to be paid out of the structure to the detriments of investors, according to one survey taker. This respondent makes the case that “the lack of a specific charge-off policy is allowing servicers/sponsors to leave bad assets in the deal while taking cash flows out of the deal, meaning that the investors are going to be left ‘holding the bag’ at the end.”

“Dealer shelf paper is particularly prone to this, as certain dealers have engaged in trigger management to keep equity cash flows going. One suggestion would be to have all deals go into turbo sequential payment mode once the clean-up call date has been hit,” said the structured finance professional.

### **Esoteric Assets, Manufactured Housing Most Prone to Risk**

Finally, the latest SF Market Opinion asked respondents to identify which asset classes they believe posed the highest potential operational risk. Not surprisingly, 52% chose newer or esoteric assets, making that the top choice, while mortgage/home equity (13%) and credit cards (10%) were considered the least prone to that type of risk.

As a closing follow-up question, the respondents were asked to rank each asset class with the type of operational risk most likely associated with it. In this question, mortgage/home equity (53%) and manufactured housing (54%) were most closely associated with servicer performance risk. CDOs (49%) and manufactured housing (46%) were most closely aligned with liquidity risk. Credit cards, meanwhile, were most associated with risks related to unsecured receivables (60%).

These last figures would seem to fly in the face of the earlier question, in which respondents indicated that mortgage/home equity was less prone to operational risk. “However, while that may be true, it indicates that operational difficulties experienced by servicers in that category are still fresh in participants’ collective memory,” said Mr. Gutierrez. “Thus, respondents may equate servicer risk with this asset class, even though generally they conclude its susceptibility to overall operational risk to be de minimis—most likely due to its commoditized nature.”

One respondent, who could only speak for mortgage-related structured transactions, emphasized, “the best way to mitigate potential operational risk is through more frequent issuer and servicer interaction.”

Overall, the results of this SF Market Opinion indicate the growing realization that multiple areas of risk exist to which transactions may be exposed to beyond the credit profile of the obligor and the underlying asset value of the collateral. Legal risks, transactional structure risks, servicer performance risks, and regulatory risks—these all have to be taken into account when analyzing a specific securitization. Equally important, all such aspects must be duly monitored over the life of a transaction to produce proper surveillance.

However, at the end of the day, some of the more cynical survey participants rely on themselves to detect operational pitfalls, staunchly subscribing to the old maxim of caveat emptor: “Thorough and regular due diligence by the buyer is the only way to manage operational risk,” one respondent stated bluntly.

By Adam Tempkin and Michael Gutierrez

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