



June 6, 2008

To: The head of structured finance for DBRS, Fitch, Moody's and S&P

From: James Callahan, Executive Director, Pentalpha Capital Group

Subject: Pentalpha's comments on proposed enhancements to the rating agency analysis process for U.S. mortgage securitizations

There has been significant discussion recently about the rating agency process for projecting consumer debt service behavior and operational risk items inherent in sub-prime mortgage securitizations. These conversations may, in part, have been sparked by a report from Moody's labeled "Proposed Enhancement to U.S. Residential Mortgage Securitizations: Call for Comments" and another from S&P titled "Efforts to Enhance Ratings and Transparency".

Pentalpha commends the rating agencies for their proactive effort in proposing enhancements to the U.S. residential mortgage securitization process. Pentalpha believes that these proposed changes are long overdue and that proper execution of such changes is very likely to generate higher investor confidence in the mortgage product. While many of the suggested changes are written in the context of sub-prime securitizations, we would encourage readers to think in terms of the entire MBS/ABS securitization process; especially prime borrower loan. The key to re-invigorating all of the MBS/ABS markets is restoration of investor confidence. We have some fresh ideas that could help.

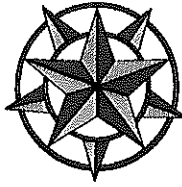
Pentalpha is an independent capital markets advisory and operations oversight firm that specializes in credit-sensitive structured credit products. For more than a decade we have been providing valuations, workout advice and strategic insight to clients with regard to maximizing value of such products. One of our affiliated companies, Pentalpha Surveillance LLC, is frequently appointed to monitor the performance of operating companies written into public and private mortgage and asset-backed securities. This role, that of performing ongoing comprehensive monitoring and forensic analysis of structured securities, we refer to as Trust Oversight Manager (TOM). In serving in this role, we have found inherent structural limitations to the common market practices and standards. While we believe that the rating agency proposals attempt to address some of these limitations, it is our opinion that the rating agency proposals fall far short.

SUMMARY RECOMMENDATIONS

We applaud efforts by the rating agencies to address concerns with respect to the pre-securitization or manufacturing process of a structured finance security. However, we believe it is as important -- if not, more important -- to address issues concerning the post-closing environment. Specifically, we believe significant enhancements are needed in structured finance transaction governance and controls. It is the inadequacy of governance and controls that exacerbated the magnitude of the recent MBS market deterioration.

Our specific recommendations can be summarized as follows:

1. Each trust should retain a truly independent vendor to oversee the numerous operational parties retained to provide an operational service to a trust. This includes oversight of the operational practices of the initial loan level due diligence firm's, trustee, originator, servicer, insurer, underwriter and derivative counterparty. In recent memory, each of these institutions contributed (some in a larger way than others) to one of the greatest



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debacles in the history of the financial system. They need oversight individually and as a group. None of them is perfect. Together, they have shown that their little errors can result in “material” problems.

2. Significantly improve the documentation related to **governance and controls** so that it enables parties to the transactions to remedy various breaches of representations and warranties and to correct errors. The current standards are not sufficiently detailed to assure efficient implementation. The current documentation standards create false confidences in terms of effectiveness.
3. Improve information so third parties can check each operating vendor’s work. Simply stating historic facts is insufficient. The agencies need to create a **comprehensive and meaningful standardized data set** to enable thorough analysis of collateral performance. The data sets that were recently proposed by one agency continues to show a lack of real understanding regarding the technical nuances of distressed loans. Simply listing more data fields are not entirely helpful.
4. In terms of “spot checking” loans after a deal closes to assure that the loans meet the original deal stipulations, we recommend the following;
 - a. Require forensic review vendors be truly **independent** by specifying that the post-securitization review be performed by a party unrelated to any other party to the transaction.
 - b. Increase the **duration** of the proposed independent third party forensic review period beyond the first 18 months (as suggested by one rating agency) of the securitization’s life.
 - c. Commence such examination **immediately** upon delinquency (not after 120 days of delinquency, as recommended by one rating agency).
 - d. Subject the parties performing such post-securitization review work to **performance testing** by the rating agencies for that function.

INDEPENDENCE OF THE TRUST OVERSIGHT VENDOR

It is essential that the vendor performing the post-securitization review be truly independent – and that entity should not be related in any way to other parties to a transaction (e.g. originator, issuer, trustee, pre-securitization due diligence firm, custodian, servicer, underwriter, initial subordinated investor). Even the perception of a potential conflict should be avoided, where possible. Independence of the ‘watchdog’ is critical. We would suggest that the investor community and rating agencies consider (and avoid):

- Diligence firms that may fail to catch problems in the pre-securitization process also being responsible for post-securitization oversight of those same loans. If a firm didn’t identify a problem loan before closing, one could argue that they are less likely to find, and/or bring attention to, an underwriting problems in the post-securitization period,
- Efforts of trustees or master servicers to expand into the post-securitization oversight business should be frowned upon. Ironically, Trustees make errors. Sometimes they are material and require restatements. For that reason, the duties of such parties to a transaction should also be reviewed within the scope of a forensic post-securitization review. Once again, we are concerned with the objectivity of such parties if they are producing the errors as well.
- Subordinate and residual holders engaging affiliated firms as credit risk managers who might be incented to work with the servicer to drag their feet on loss recognition,



- Wall Street dealers or hedge fund owners of servicing companies who may have a leveraged, vested interest in a deal's performance via the credit default market.

VENDOR QUALIFICATIONS AND SCRUTINY

In addition to asserting their independence from transaction-related entities, Trust Oversight Managers performing such independent post-securitization reviews must be qualified to perform the many activities suggested here. Their competency for each of the oversight functions (originations, servicing, derivative payment processing, trustee reporting) should be reviewed, and possibly rated, by the rating agencies in a manner similar to that of mortgage servicers. Assessment of capabilities and expertise should include demonstration of adequate resources (both headcount and systems), performance testing, related work experience, and internal quality controls. It is the consistency of the workflow process, specialized systems and seasoned personnel that can comfort investors that everything is being performed as contracted. Oversight should be a rigid process.

GOVERNANCE AND CONTROLS

It is our view that one agency's specific recommendations regarding governance and controls fall significantly short of a Best-in-Class solution. While we embrace their suggestion for the role of an independent third party to perform a post-securitization loan review, the role of such a party as suggested by that agency's comments is much too limited. We strongly advocate that there is a need for such an entity to have a much broader and more involved role than outlined in that one agency's proposal.

With respect to perceived breaches of representations and warranties, we believe that transaction documents must provide a more concise set of operating guidelines for determining the process for evaluation, submission, and repayment. A notable focus is with trust's that are serviced by affiliates of the lender. Such servicers have little incentive to put back bad loans to their corporate parents or affiliates. It is worth noting that Credit Risk Managers or Trust Oversight Managers can identify and recommend put-backs but it's important to note that most transaction documents clearly define this as the servicer's responsibility.

Pentalpha has seen many situations where representation breach letters are repeatedly challenged by servicers as a stalling tactic to avoid repurchase due to their deteriorating financial condition. As such, we note that it is not sufficient to simply strengthen the representations and warranties, but it is equally important to proscribe the operational process that all parties must follow in resolving breaches of such representations and warranties. We would suggest negative covenants be applied in many cases. For example, if it is discovered that a loan appears to have an error or breaches a representation, then the loan must be put back to the originator unless the responsible party can prove otherwise. Additionally, failures to acknowledge the servicer's repurchase requests should be reported to the rating agencies and all investors. Because of the effectiveness of these provisions, the rating agencies should reduce subordination levels on deals with negative covenants and severely penalize deals without them.

Currently, most deals have positive covenants, requiring investors and other appropriate parties to prove breaches in minute detail before the responsible party responds. This is often a significant waste of time, often with no "hammer" for the party to "do the right thing". The resolution rules need to be enhanced or the representations and warranties will continue to have little value.



COMPREHENSIVE DATA

As self-described “data hogs”, Pentalpha strongly supports the agency’s quest for additional data from the Servicers. The data needs to be in a format that lends itself to analysis, contains items that are actionable, and makes note of cures applied. Each field must have an analytical application. We are concerned that some of the recent additions still show a lack of advanced understanding of the technicals affecting sub performing loans. For instance, mere “foreclosure status” is wholly inadequate and naive. What is needed is the “date of the legal foreclosure filing” so compliance tests can be run and an investor (and agency) can estimate when a loan will be resolved.

Pentalpha recognizes that the logistics of making such data available may be extraordinarily difficult. Servicers systems are not uniform and particularly with respect to the servicing of delinquent loans, systems vary widely. Many servicers have built add-on modules to off-the-shelf servicing platforms while others have hired vendors with stand-alone systems. And yet, others have taken steps to archive data, notes, and other information necessary for servicing. We believe that the rating agencies should move to requiring a standardized, but much more comprehensive, data reporting set. Servicers need to be able to demonstrate that they can comply with those standards and failure to do so would result in such related transactions being awarded large negative rating agency factor adjustments.

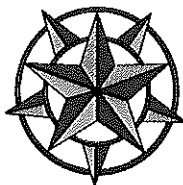
As Trust Oversight Manager, the Pentalpha’s data tape layout is more than 500 fields of items to facilitate **proactive** monthly oversight. It is our opinion that not providing those fields, or not doing so in an analytically usable form, says volumes about a servicer’s ability to understand and effectively manage all aspects of a loan’s risks. Some servicers will argue that the industry standard for data disclosure is far less than suggested by Pentalpha or the new rating agency proposals and thus would question the need for more data. We believe that given the most recent experience, servicers owe this information to investors and independent Trust Oversight Managers. The expansion of data fields may be an additional cost to Servicers, but the current level of disclosure is not generating sufficient investor confidence. Data needs to be expansive, consistent across issuers, and transparent.

Some transactions have included another variation of a post-securitization review vendor, a Credit Risk Manager (CRM). In some cases a CRM acts as merely an elaborate database vendor that augments trustee reports and lets investors do their own data mining. We believe such an arrangement is insufficient. Data alone is not enough; it is oversight manager’s immediate analysis, proactive negotiation, and reimbursement activities undertaken by its internal seasoned workout specialists that adds the most stability. While the data is important, it is human analysis and intervention that causes errors to be identified and repaired.

SCOPE AND DURATION OF POST-SECURITIZATION REVIEW

The independent third party post-securitization review should be much broader in scope and more proactive than merely responding to credit problems after they occur. Pentalpha strongly believes that in addition to reviewing servicers, other parties to a transaction must also be subject to review, including trustees and derivative counterparties.

The MBS industry is well-aware that REMIC deals are prone to many operational problems that include calculation and payment errors by trustees, lack of a defined process for repurchase by the originator for



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breaches of representations and warranties, and calculation and payment errors by derivative counterparties. We believe this full range of issues should be addressed in the post-securitization reviews undertaken by a Trust Oversight Manager. Additionally, it should cover more than the first 18 months of a transaction that was proposed by one agency.

As an example, we have found that “tying out” data to the penny among multiple sources within a deal each month is essential. This is a costly manual process but it provides potentially valuable information about operational shortcomings, system flaws and erroneous modeling assumptions. In our experience as a Trust Oversight Manager, we have repeatedly identified significant differences between the servicer and trustee reports. Differences ranging from minor to extremely significant items; they include missing loans, modified loan balances, REO proceeds having been misapplied, erroneously liquidated loans being re-activated etc. Derivative calculations should also be independently reviewed every month - as opposed to having the derivative counterparty themselves providing the numbers. We have found significant errors in payments of such contracts. And we note that most transactions do not have an independent calculation agent which we believe is a material governance flaw.

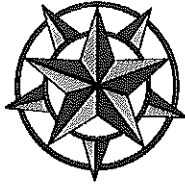
As mentioned earlier, limiting this independent loan file forensic review to only the first 18 months, as one rating agency has proposed, ignores the realities of current market problems. While there is merit to a reconciliation process that runs the term of a deal, we believe, at a minimum, such a process should be in place until several months after the last of the initial loan resets and the expiration of any derivative contracts.

IMMEDIATE LOAN LEVEL REVIEW AND RECONCILIATION

Pentalpha strongly disagrees with one agency’s recommendation that loans be reviewed at 120 days delinquency. This is much too late. Investigative work needs to be done immediately (60 days). As a seasoned Trust Oversight Manager, we have experienced the best results when a problem loan is analyzed and action taken immediately. While some reported delinquencies may be caused by accounting or data errors, Pentalpha strongly believes that by waiting until 120 days has passed to begin a review, valuable time is lost during which remedial action might have been beneficial. Failure to identify and reconcile issues at the earliest point possible is imprudent given recent history and could mask true performance.

We would recommend that this loan level “review” of a delinquent asset consist of an analysis of all delinquent loans each month using a comprehensive data set provided by the Servicer to the Trust Oversight Manager. Such ongoing monitoring of loans by an independent party is important for a number of reasons including;

- (i) Early identification of early payment defaults. Start the buyback process early to reduce counterparty financial strength concerns,
- (ii) Tracking of loans which may exhibit performance characteristics inconsistent with expectations based on origination data – which may assist in the identification of origination errors,
- (iii) Highlighting of notable changes to other key indices such as FICO score, house value, etc -- which could be used as management tools to improve servicing, and
- (iv) Identification of reporting and data discrepancies between servicer and trustee.



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A PRICE FOR EVERY RISK

While we feel that the rating agencies should require a more robust governance process regarding the post closing period, we realize that some participants (like the issuers and dealers) may disagree because of cost and aggravation concerns. We accept these differences of opinion. We just want the rating agencies to require more credit support if these Best-in-Class governance tools are not included.

TRUST OVERSIGHT: A BEACON IN TREACHEROUS WATERS

As a Trust Oversight Manager, we have often been asked to prove our “value”. We view such requests as being similar to a public safety officer responding to a question regarding the value of a lighthouse at treacherous points of land. The mortgage securities market has just been through a period where ship after ship has run ashore in troubled waters. Can you really measure how many ships might have avoided hitting obstacles or running aground because they saw the beacon of light and steered to safety? The mortgage securities industry needs to have the same type of structural safety mechanism even though virtually everyone has a GPS these days. Given recent experience, regulators and investors are demanding additional fail safe tools to repair unintended problems. Post closing governance must be enhanced. The rating agency’s concept of having a lighthouse – an independent Trust Oversight Manager – is a good one but, as originally proposed, does not go far enough. They are proposing that a lighthouse is included but the light is too dim. Pentalpha recommends that the lighthouse light be brighter and on all the time to inspire confidence, not just after wrecks (severely delinquent loans) have already begun washing up on shore.

We recognize that any rating agency that proposes this appropriate level of post closing governance, or requests additional data, runs the risk of losing business to other rating agencies. This is because issuers, underwriters, and investors might “shop” for a deal’s capital structure that doesn’t bear this expense. We think that this would be very short-sighted by those parties. To create a level cost structure across all deals, we encourage all rating agencies to strongly consider requiring all asset backed deals to include an independent third party for comprehensive post-securitization review. The cost of a Trust Oversight Manager is generally a few basis points on the outstanding balance of a trust. As such, only a few loans need to be cured or repurchased to recover such additional ongoing cost to the Trust.

Again, we applaud the rating agencies for moving the dialogue forward by making a number of recommendations to address the turmoil in the mortgage securities markets. In addition to supporting the pre-securitization enhancements suggested by the rating agencies, we believe that enhancing the post-securitization environment with better governance and controls, a more empowered and experienced watchdog, the Trust Oversight Manager, and better rules and penalties to assure compliance, will lead to greater investor confidence and will strengthened the markets for long-term sustainability.

We appreciate the opportunity to comment and would be happy to share our thoughts in greater detail. Please call us at 203 660 6100 to discuss your thoughts. Or, visit our web site at: www.Pentalphaglobal.com

