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Introduction

The rating criteria described herein will generally be applied to ratings of RMBS Servicer Advance Receivables securitizations ("Advance Securitizations") by Morningstar Credit Ratings, LLC ("Morningstar"). The methodology is designed to be easy to understand and the framework can be consistently applied to Morningstar-rated advance securitizations while incorporating issuer-specific quantitative and qualitative data. A rating that is assigned based on these criteria should provide market participants with a risk benchmark that can be used to gauge the relative default risk of a security against that of other servicer advance securities. This methodology will be effective when Morningstar issues its first presale report on an advance securitizations.

In RMBS securitizations, servicers are generally required to advance payments on delinquent loans to augment liquidity and to preserve the collateral value. Advance types include principal and interest, escrow, and corporate advances, which are defined below.

- P&I advances are those amounts advanced to a securitization trust to cover delinquent payments of principal and interest due from the individual mortgages.
- Escrow advances are the payments made to preserve the mortgage lien, such as advances for unpaid taxes and insurance.
- Corporate advances are expenses related to the foreclosure and REO process that are incurred to maintain the property value and to dispose of the property.

Loan-level advances are generally reimbursable from cash flows of the particular loan and recovered at the time the related loan is modified, cured of its delinquency, or it is liquidated. If the liquidation proceeds are inadequate to cover the balance of the outstanding servicer advances and the servicer has determined the advance to be nonrecoverable, the remaining advances may be reimbursed from the aggregate collection accounts on the loans within the same RMBS trust.

Pool-level advances are reimbursable by cash flows from the pool of loans in the underlying trust and are generally reimbursed monthly; therefore, pool-level advances usually have faster recovery rates than loan-level advances.

Section 1 - Advance Receivables Securitization Structure

Advance securitizations allow servicers to finance advances of delinquent payments made on RMBS securitizations by pledging the reimbursement of those advances to the advance securitization trust. Reimbursement of these advances usually happens at the top of the waterfall in the underlying deals.

Advance securitizations are usually set up as master trusts with a series of indenture agreements defining the terms of the deal. Typically, each series will issue a variable funding note and one or more term notes, which may have an aggregate maximum principal balance allowed by the servicer advance trust. There is a revolving period during which the TN holders receive interest only, while the VFN may receive both interest and principal payments with the balance of the VFN varying on a daily basis as a result of additional advances made and collections on existing advances. At the end of the revolving period, no additional servicer
advance receivables may be added to the pool and the servicer is no longer able to draw upon the VFN. At that time, the notes are paid down from the advance reimbursements collected by the servicer according to their priority in the waterfall. Alternatively, the issuer can repay the notes in full through refinancing them with a new series of notes or from other sources of financing.

Section 2 - Methodology of Determining Advance Factors
The Morningstar advance securitization rating process begins with a review of the servicer’s historical data on rates of advance reimbursements. Incorporating this data, as well as quantitative and qualitative factors, any results of an operational risk assessment of the servicer and a cash flow analysis of the capital structure, Morningstar will determine discount factors for advances that will be deposited into the advance securitization trust for each rating level.

Risks inherent in advance securitizations include:
× Liquidity: the timing of reimbursement;
× Recoverability: whether advances are recoverable, and the source of the recovery;
× Condition: the financial condition and operational efficiency of the servicer;
× Structure: the waterfall of payments to bondholders and the performance triggers; and
× Legal: whether the advance receivables are a true sale and security interests are properly perfected.
Liquidity

The expected timing of reimbursements and the ultimate reimbursement rate differ across the various servicer advance types and across jurisdictions. For the purposes of Morningstar’s analysis, the analysts identify whether the underlying property for loan-level advances is in a judicial foreclosure or a nonjudicial foreclosure jurisdiction. In a judicial foreclosure jurisdiction, the mortgage lien on the property generally must be transferred in a court proceeding that terminates the borrower’s right of redemption, while a nonjudicial foreclosure jurisdiction generally permits the title to be transferred outside of any court proceeding. Therefore, the timing of reimbursements and the ultimate reimbursement rate are generally shorter in non-judicial foreclosure jurisdictions than in judicial foreclosure jurisdictions. For loan-level advances, if the servicer deems them nonrecoverable, the servicer may be reimbursed from general cash flows of the underlying RMBS securitization. Historically, the cumulative reimbursement rates have been less than 100% for all types of servicer advances.

The timing of the servicer advance reimbursements is important because the servicer advance receivables do not pay interest, but interest must be paid on the advance securitization bonds. Morningstar will typically review the historical advance reimbursement rates of the servicer to determine expected amounts to be collected over time and to derive a reimbursement timing curve. Because the reimbursement rates in more recent vintages are more relevant to expected performance in the near future, Morningstar may weigh the more recent reimbursement rates more heavily. The values in the following table show an example of how the historical reimbursement rates may be weighted to derive an expected-case reimbursement timing curve. Morningstar may adjust these weights as market conditions evolve and as additional performance information is accumulated.

<table>
<thead>
<tr>
<th>Period</th>
<th>Weight (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>T-1 to T-12</td>
<td>40</td>
</tr>
<tr>
<td>T-13 to T-24</td>
<td>30</td>
</tr>
<tr>
<td>T-25 to T-36</td>
<td>15</td>
</tr>
<tr>
<td>T-37 to T-48</td>
<td>10</td>
</tr>
<tr>
<td>T-49 and Earlier</td>
<td>5</td>
</tr>
</tbody>
</table>

Once the expected-case reimbursement timing curve is determined, Morningstar may stress the liquidity at each rating level by assuming a delay in advance reimbursement. The length of the delay will depend on the type of advance receivable, the type of jurisdiction covering the underlying mortgage, and the rating level.

Recoverability

Historically, cumulative reimbursement rates are generally less than 100%, so Morningstar will generally stress the recovery rates. The stress can be applied by reducing the expected reimbursement amount each month, capping the recovery rate used in the analysis, or by reducing the calculated reimbursement rate. The amount of the adjustment will depend on, among other things, the type of advance receivable, the type of jurisdiction covering the
underlying mortgage, and the rating level; these adjustment rates are typically based on historical data received from servicers and independent analysis conducted by Morningstar. Even in cases where a servicer provides historical data showing a 100% reimbursement rate, the timing of the final reimbursements may be too late to be of value in the advance securitization. An example of expected case adjustments is shown in the following table, but these values may be altered for an individual servicer depending on the results of the Morningstar operational risk assessment of the servicer, and the characteristics of the particular transaction as necessary. Additionally, these values can be stressed for each rating level above the expected case.

**Table 2 – Expected Case Adjustments Example**

<table>
<thead>
<tr>
<th>Type of Advance Receivable</th>
<th>Reduction of Cumulative Reimbursements (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Pool-Level P&amp;I</td>
<td>0.25</td>
</tr>
<tr>
<td>Loan-Level P&amp;I Judicial</td>
<td>1.00</td>
</tr>
<tr>
<td>Loan-Level P&amp;I Nonjudicial</td>
<td>0.50</td>
</tr>
<tr>
<td>Escrow Judicial</td>
<td>1.50</td>
</tr>
<tr>
<td>Escrow Nonjudicial</td>
<td>1.00</td>
</tr>
<tr>
<td>Corporate Judicial</td>
<td>2.00</td>
</tr>
<tr>
<td>Corporate Nonjudicial</td>
<td>1.50</td>
</tr>
</tbody>
</table>

**Financial Condition of the Servicer**

The financial condition of the servicer is important to the performance of the advance securitization. If the financial condition of the servicer deteriorates such that the collections and other servicer-replacement triggers in the underlying RMBS securitization fail, the servicer may be removed from the underlying RMBS securitization, causing an interruption in the servicer advance reimbursements. Morningstar may review the financial condition of the servicer and may adjust the reimbursement timing and amounts when deriving the expected reimbursement curves. This review may incorporate a Morningstar, Inc. credit rating¹ of the servicer or its parent, if available. Otherwise, Morningstar may perform an assessment of the servicer by reviewing the servicer’s financial statements, strategy, history, and management experience. Morningstar also expects that the terms of the advance securitization will contain triggers that will cause early amortization if the financial condition of the servicer deteriorates.

**Structural Mechanisms**

Morningstar expects that the advance securitization transaction documents will provide certain structural mechanisms in order to mitigate the particular risks associated with the transactions. The absence of these structural mechanisms may be a consideration in the determination of the advance discount factors to be used in the ratings process.

¹ The credit ratings of Morningstar, Inc. are not NRSRO credit ratings, and therefore are not subject to our policies, procedures, and methodologies with respect to our credit ratings or laws and regulations with respect to NRSRO activities.
**Reserve Fund**

Because reimbursement rates on servicer advances can be volatile, a reserve fund is often established to provide liquidity for the advance securitization bondholders. Reimbursement rates actually achieved by the servicer will exhibit volatility in comparison to the expected case generated by Morningstar’s analysis. To determine that bondholders will be paid the required interest, Morningstar typically expects an interest reserve fund to be established. The specific servicer, the structure of the advance securitization, and the market conditions will generally be incorporated into Morningstar’s review of the size of the reserve fund. The reserve fund should typically be fully funded at closing and be replenished in the advance securitization waterfall. An advance securitization structure without the expected initial reserve fund may result in Morningstar adjusting the discount factors used in its rating analysis.

**Early Amortization**

The terms of the advance securitization transaction documents should have the appropriate triggers that require early amortization when the performance of the servicer declines or the servicer fails to perform certain obligations during the revolving period. The triggers may include, but are not limited to, reductions in the discount factor based on actual reimbursement rates and actual liquidation period timelines experienced in the underlying RMBS securitizations.

**Eligibility Criteria**

The advance securitization transaction documents will define eligibility criteria for each type of servicer advance receivable being deposited into the advance securitization trust. Pool-level eligibility criteria will also be established covering the underlying securitizations. As the underlying RMBS securitizations season, and the percentage of delinquent mortgage loans in those pools increases, the amount of cash flow available to reimburse pool-level advances and nonrecoverable loan-level advances is reduced. Morningstar may perform a cash flow analysis of the underlying RMBS securitizations and review eligibility criteria when determining the discount factors to be used in the ratings process.

**Legal Issues**

Morningstar will review the transaction documents, including formation and operative documents to determine if the advance securitization is exposed to risks that are new or unique to the transaction. The review will determine, by an examination of the transaction documents on the underlying RMBS securitizations or some other analysis, that the servicer advances are reimbursed at the top of the waterfall, because a lower position in the waterfall could negatively affect the reimbursement rate. Generally, the terms of the RMBS securitization include a description of the servicing standard of care required of the servicer that will service the mortgage loans in the RMBS securitization. The servicing standard will typically enumerate that: (a) a servicer use customary and usual servicing practices of a prudent servicing institution that services mortgage loans of the same type as mortgage loans in the trust in the jurisdiction in which the related mortgage properties are located; (b) a degree of care that is no less than what the servicer exercises when servicing comparable loans for itself, affiliates, or other third parties; and (c) a standard that is without regard to the servicer or its affiliates’ ownership of any particular securities. Any variance to standards less than those set forth herein will be a consideration in determining the discount factors used in the ratings process.
Morningstar will review the legal opinions delivered as part of its legal review process. With respect to the legal opinions, a primary concern is how a voluntary or involuntary bankruptcy of the servicer would affect the collections of the advance securitization. Typically, in either type of bankruptcy a stay is instituted that prevents the servicer’s creditors from collecting further debts from the servicer and preventing the instituting or continuing of any action to obtain property from the servicer. In order to avoid the servicer advance receivables becoming part of the servicer’s bankruptcy estate subject to the stay, action must be taken so that the transfer of the servicer advance receivables to the advance securitization trust is a “true sale,” meaning that the advance securitization bondholders are secured creditors only of the advance securitization issuer and not creditors of the servicer, and the servicer advance receivables will not be included in the servicer’s bankruptcy estate. Additionally, Morningstar expects that there will be protections in place to prevent the bankruptcy court from exercising its discretion to apply substantive consolidation to the transfer of the advance securitization assets, which would allow creditors of each entity to reach the assets of the entire consolidated estate by consolidating the advance securitization trust assets, and potentially others, with those of the servicer. These expectations will be confirmed by the related opinions.

Section 3 - Morningstar Operational Risk Assessment

Morningstar ranks mortgage servicers on a scale of 1 to 4 as follows: 1) exceeds prudent standards, 2) demonstrates proficiency in standards, 3) demonstrates adequacy in standards, and 4) fails to meet one or more requisite standards. For details, please refer to Morningstar’s publication, “Operational Risk Assessment for Residential and Consumer Finance Servicers and Vendors.” The Morningstar servicer ranking is a forward-looking operational risk assessment of the servicing capabilities of a mortgage servicer. Specifically, the Morningstar ORA group conducts on-site evaluations with a focus on management tenure and business strategy; audit and quality assurance methodologies; loan administration and customer relationship management; collection strategies; loss mitigation effectiveness and foreclosure caseload management; REO marketing timelines; loss accounting and related financial strategies; technology architecture and organizational infrastructure; legal and regulatory controls; and vendor oversight and certification.

The operational risk assessment will also incorporate a servicer performance score on a scale of SBC1-SBC5 (SBC5 being the best), which measures the effectiveness of a servicer to collect cash relative to the universe of servicers over a rolling 12-month period. This performance score will be weighed in as one of the factors determining an overall servicer ranking. Morningstar will incorporate the servicer ranking (if available) and the servicer performance score when reviewing the reimbursement timing and unrecoverable stresses in determining the advance factors. The absence of a servicer ranking may lead Morningstar to use a more conservative approach in determining the discount factors used in the ratings process.
Section 4 – Ratings and Rating Actions of Other Rating Agencies

Although we monitor the actions taken by other credit rating agencies, our credit ratings and outlooks are not linked to the ratings, outlooks, ratings actions, or methodologies of other credit rating agencies.

On a case-by-case basis, Morningstar may review the publicly available ratings of other rating agencies when analyzing an advance securitization. For example, ratings of other rating agencies may be one of many data points reviewed when assessing the creditworthiness of counterparties to a transaction.