

## **Guide to due diligence requirements for investing in a securitisation position**

by the AMIC Securitisation Working Group

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### **Introduction**

Securitisation has been in the regulatory spotlight since the global financial crisis started in 2008. In Europe, this has culminated with the finalisation of the new European Securitisation Regulation (SR) that came into effect on 1 January 2019. The SR establishes a general framework for securitisation and in particular sets out detailed due diligence (including risk retention and other verification requirements) that must be conducted by institutional investors before and whilst holding an exposure to a securitisation.

The Asset Management and Investors Council (AMIC), through its Securitisation Working Group, has been active in helping shape the SR over the past few years by engaging with the regulators and working closely with other industry organisations to co-ordinate responses and suggestions to the regulators as much as possible.

The aim of the AMIC Securitisation Working Group is to help revive the securitisation market. With this aim in mind, we have put together this guide to the SR due diligence requirements to explain, in broad terms, what the due-diligence requirements are and additionally to provide potential investors with some practical guidance as to what information should be obtained and where this information can be obtained from.

Whilst the SR came into effect on 1 January 2019 it is important to note that the SR is not only applicable to securitisation transactions in which its securities were issued on or after 1 January 2019, but also, with respect to a securitisation position held prior to this date, where new securities are issued with respect to that transaction on or after 01 January 2019. For securitisation products issued before 1 January 2019 the due-diligence requirements and retained interest provisions used prior to the SR will continue to apply.

### **Due-diligence requirements prior to holding**

According to the SR, prior to holding a securitisation position an institutional investor is required to carry out a due-diligence assessment which enables the investor to assess the risks involved in both the securitisation position and the underlying exposures. The due-diligence assessment also includes verification of the risk retention requirements an originator, sponsor or original lender has now a direct obligation to comply with.

In broad terms, an institutional investor needs to confirm the following:

1. Check that the originator, sponsor or special purpose vehicle (SPV) has made all the required disclosures as required under the SR;
2. Check that the originator, original lender or sponsor (the risk retention holder) complies, or will be complying once the transaction closes, with the 5% risk retention requirements. Institutional investors should note the risk retention requirements also apply to third country (i.e.: non-EU) risk retention holders as well, although the obligations do differ slightly for a EU-based risk retention holder. Institutional investors should be able to verify compliance with the risk retention requirements by looking at the disclosure set out in the prospectus, or, with respect to transactions not requiring a prospectus, the underlying transaction documents or risk retention memo customarily provided by legal counsel, and in regular investor reports; and

3. The investor needs to assess whether the originator (or original lender) complies with the credit granting requirements set out in the SR and that the credit-granting is based on a thorough assessment of the obligor's creditworthiness. Investors should be aware that the SR specifies different credit granting criteria dependent upon whether the originator / original lender is a credit institution and / or whether it is based in the EU or a third-country.

Once the above is complete, the investor can look at the actual assets. When assessing the risks involved, at the very least, the following need to be taken into account:

1. The risk characteristics of the individual securitisation position;
2. The risk characteristics of the underlying exposures; and
3. All the structural features of the securitisation that can materially impact the performance of the securitisation position (e.g. the contractual priorities of payment, priority of payment-related triggers, credit enhancements, liquidity enhancements, market value triggers, and transaction-specific definitions of default).

When investing in an asset-backed commercial paper (ABCP) programme, note that certain specific requirements should be met by the sponsor. In this situation, the investor due diligence process should involve making sure that the sponsor has done the above checks while also considering the features of the ABCP programme and the full liquidity support.

If the securitisation has (or will have on close) a simple, transparent and standardised (STS) designation, an investor may place some reliance on this STS notification, and on the information disclosed by the originator, sponsor or SPV about its compliance with the STS requirements. However, investors should be aware that reliance by the investor on the STS designation should not in any way be considered as a substitute for completing their own due diligence required under the SR

#### **Where to find the relevant information**

An initial set of documents that any investor initiating their due diligence process should start with is the SR Article 7 originator disclosures. This article lays out a list of the minimum information an originator, sponsor or SPV is legally required to provide to an investor. The obligation to provide the information is on the originator, original lender or SPV. Failure to do so can result in administrative sanctions, remedial measures (including financial) and may also carry criminal sanctions. These disclosures are expected to emerge as a minimum that regulators will require investors to consider when analysing securitisation investments.

In order to assess the risk of the individual securitisation position an investor should also look at the:

- representation of standard cash flow sequence (waterfall) of the transaction;
- details of structural triggers leading to different waterfalls being activated; and
- potential for conflict with other investors, particularly where concepts such as controlling class are utilised in determining voting rights.

The above can be found in the prospectus, transaction summary (if applicable) or underlying transaction documentation.

An investor can get a good idea of the risk of the exposures underlying the securitisation position by looking at the:

- loan level data appropriate to underlying asset type;
- portfolio stratification tables, analysed for identification of any notable patterns or concentrations;

- representation of borrower credit quality particularly in transactions backed by non-granular loan portfolios or backed by unsecured borrowings such as credit cards; and
- external credit rating agency assessments.

The structural features of the securitisation product can be identified by looking at the:

- prospectus disclosures, or with respect to a private transaction, the underlying transaction documentation or transaction summary;
- key risks focus of legal and accountancy advisors (typically identified in the prospectus);
- understanding of transaction performance metrics and how these might alter the allocation of cash flows; and
- capture output from a scenario modelling analysis, either using their own models or those provided by third parties.

### **Ongoing due diligence and monitoring requirements**

Due diligence is also required on an ongoing basis once a product is held. An investor holding a securitisation position needs to, in broad terms, at least do the following:

1. Establish written procedures in order to monitor performance of the securitisation position and of the underlying exposures (e.g. monitor the percentage of loans more than 30, 60 and 90 days past due, default rates, prepayment rates, loans in foreclosure, recovery rates, etc);
2. Regularly perform stress tests on the cash flows and collateral values of the underlying exposures or on loss assumptions. The stress tests could take the form of sensitivities on loss assumptions such as reverse stress testing to understand the impact of the probability of default (PD) and the loss given default (LGD). These also need to take into account structural features such as triggers, priorities of payments etc.
3. Must have in place an appropriate governance framework that identifies the risks associated with securitisation investments and ensures that senior management are informed of how these risks are managed;
4. Be able to demonstrate, to its competent authorities, that it has a comprehensive understanding of its securitisation position and underlying exposure; Investors need to have suitable systems in place to facilitate the necessary record keeping. Documentation will need to cover related processes and procedures, for example risk manuals and SR compliance checklists for different transaction types; and
5. When holding ABCP programmes, investors need to regularly perform stress tests on the solvency and liquidity of the sponsor and be able to demonstrate, on request, a comprehensive understanding of the credit quality of the sponsor and of the terms of the liquidity facility provided. Investors need to understand the nature of liquidity support, when it will be activated and to what extent it covers defaults as well as dilutions on assets.