

Guide to due diligence requirements for investing in a securitisation position

[for an institutional investor in scope of the EU Securitisation Regulation,
other than when acting as the originator, sponsor or original lender]

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 17 January 2018 and applies in general to securitisations that issue new securities (or otherwise create a new securitisation position) on/after 1 January 2019. It should be noted that pre-1 January 2019 securitisations are grandfathered, so that investor due diligence (and risk retention) requirements under previously applicable regimes (i.e. pre-1 January 2019 CRR, AIFMR and Solvency II regimes) continue to apply, as long as no new securities are issued and/or no new securitisation position is created in respect of such pre-1 January 2019 securitisation.

The SR establishes a general regulatory framework for securitisations and in particular sets out detailed due diligence (including risk retention and other verification requirements) that must be conducted by certain European-regulated institutional investors (defined as per Art 2(12) of the SR) 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.

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 certain matters. In broad terms, an institutional investor needs to verify the following:

1. that the originator, sponsor or special purpose vehicle (SPV) has, where applicable,¹ made available the information required by the applicable transparency requirements of the SR;
2. 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

¹ Note that industry discussions are ongoing with regard to the interpretation of the application of the SR transparency requirements on non-EU securitisations via investor due diligence requirements, including that the extent to which EU standardised template-based loan-level and investor reporting is required, given that such SR transparency requirements are only directly applicable to EU-established originator, sponsor or securitisation SPV issuer.

risk retention requirements now apply directly to EU-established originator, original lender or sponsor and, as before, also apply indirectly (via the due diligence requirements) to third country (i.e. non-EU) risk retention holders. 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, 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. Note that an adjusted application of credit granting verification applies in the case of fully supported asset-backed commercial paper (ABCP) transactions.

In addition to the above, an institutional investor, prior to holding a securitisation position, is also required to carry out certain due diligence assessments with regard to the risks involved, and should consider at the very least the following:

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 (including 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 a fully supported ABCP programme an adjusted approach to due diligence assessments and monitoring applies.

If the securitisation has (or will have) a simple, transparent and standardised (STS) designation, an investor may place (to an appropriate extent) 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

On deals involving an EU-established originator, sponsor or SPV, the SR transparency requirements will be directly applicable to such entities and, as such, the prescribed disclosures and reporting requirements will provide the relevant starting point. In particular, it should be noted that an initial (in draft form) set of transaction documents essential for understanding the transaction (including, if applicable, a transaction summary and an STS notification) is required to be disclosed pre-pricing. Such disclosures on securitisations involving a Prospectus Directive-compliant prospectus (i.e. "public" securitisations) must be made available to holders of a securitisation position and, upon request, to potential investors, via an EU-authorized securitisation repository or, if none exists, via a public website that meets certain prescribed requirements. There are no prescribed requirements for how such information needs to be made available on non-public (i.e. "private") securitisations, so the manner in which the relevant information will be made available to investors on such deals will need to be confirmed with the relevant transaction parties.

The SR transparency requirements are direct obligations of an EU-established originator, sponsor or SPV and failure to comply can result in administrative sanctions (including punitive fines), remedial measures and may also carry criminal sanctions.

As noted above, the industry discussions are ongoing with regard to the interpretation of the application of the SR transparency requirements on non-EU securitisations via investor due diligence requirements, including the extent to which EU standardised template-based loan-level and investor reporting may be required.

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 – note that under the SR transparency requirements, EU-established originator, sponsor or SPV is required to provide template-based quarterly loan-level and investor reporting and certain ad hoc disclosures in the case of a significant change;
- 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.