

A summary of due diligence implementation guidance

This document provides a short guide for organizations investing in ABS, MBS or Structured Credit. Our aim is to summarize the demands placed on investors today, along with the guidance by industry bodies on how to address global due diligence requirements.

The US ‘Final Market Risk Capital Rule’ installed a due diligence framework for US investors. This is consistent with investor requirements implemented in the EU via the Capital Requirements Directives (CRD), Solvency II and AIFMD.

Implementation guidance has been delivered by the European Banking Authority (EBA, previously CEBS) in the EU, which focused on Article 122a of the CRD, and The American Securitization Forum, which released a final guide to its members on the implementation of US Due Diligence for Securitization Positions. Both highlight the need for robust operational systems to comprehensively analyze and manage securitization exposures.

Overleaf is a consolidated summary of the key components of the requirements and implementation guides.

Comprehensively analyze investments	Perform ongoing surveillance and risk management	Implement operational controls and timely reporting
<p>Know the risk characteristics</p> <ul style="list-style-type: none"> US Final Market Risk Capital Rule: Due Diligence Requirements for Securitization Positions CRD III Article 122a: CEBS, Para. 4 (b); 87 Solvency II: EIOPA (CEIOPS), Article 135 AIFMD, Article 17; ESMA, section IV.VI OCC’s Dodd Frank 939A amends: 12 CFR, 1 & 1.5 	<p>Monitor, on an ongoing basis and in a timely manner, performance information on the exposures underlying securitization positions</p> <ul style="list-style-type: none"> US Final Market Risk Capital Rule: Due Diligence Requirements for Securitization Positions CRD Article 122a: CEBS, Para. 5 (b); 87 Solvency II: EIOPA (CEIOPS), Article 135 AIFMD, Article 17: ESMA, IV.VI OCC’s Dodd Frank 939A amends: 12 CFR, 1 & 1.5 	<p>Address regulatory due diligence, reporting and audit requirements now; ensure flexibility to evolve with changing requirements</p> <ul style="list-style-type: none"> US Final Market Risk Capital Rule: Due Diligence Requirements for Securitization Positions CRD Article 122a: CEBS, Para. 10 Reg AB II: SEC AIFMD, Article 17 (2); ESMA VIII.III. BIS: Report on Asset Securitisation; 3.4.1
<p>Know the risk characteristics of underlying exposures</p> <ul style="list-style-type: none"> US Final Market Risk Capital Rule: Due Diligence Requirements for Securitization Positions CRD Article 122a: CEBS, Para. 4 (c); 88 Solvency II and AIFMD (as above) OCC’s Dodd Frank 939A amends: 12 CFR, 1 & 1.5 		<p>Access and consolidate the management of all relevant securitization data (market pricing, deal issuance, collateral performance, or loan level) in a single operational environment. Draw in this data on-demand as appropriate for each asset, to perform due diligence in a timely and comprehensive manner.</p> <ul style="list-style-type: none"> US Final Market Risk Capital Rule: Due Diligence Requirements for Securitization Positions CRD Article 122a: CEBS, Para. 10 Reg AB II: SEC AIFMD, Article 17 (2); ESMA VIII.III.
<p>Impact of structural features on a position</p> <ul style="list-style-type: none"> US Final Market Risk Capital Rule: Due Diligence Requirements for Securitization Positions CRD Article 122a: CEBS, Para. 4 (c); 90 Solvency II and AIFMD (as above) OCC’s Dodd Frank 939A amends: 12 CFR, 1 & 1.5 		<p>Streamline business-wide processes, eliminate spreadsheet reliance and ensure data integrity</p> <ul style="list-style-type: none"> Solvency II: EIOPA (CEIOPS), Article 135
<p>Know the reputation and loss experience of originators related to the position</p> <ul style="list-style-type: none"> US Final Market Risk Capital Rule: Due Diligence Requirements for Securitization Positions Art. 122a: CEBS, Para. 4 (d) Solvency II and AIFMD (as above) 		<p>Deal and portfolio wide risk surveillance and stress testing for independent assessments and reporting</p> <ul style="list-style-type: none"> US Final Market Risk Capital Rule: Due Diligence Requirements for Securitization Positions CRD Article 122a: CEBS, Para. 4; 92 & Para. 5 Solvency II and AIFMD (as above) OCC’s Dodd Frank 939A amends: 12 CFR, 1 & 1.5
<p>Know an originator or sponsor’s net economic interest in a securitization</p> <ul style="list-style-type: none"> US Final Market Risk Capital Rule: Due Diligence Requirements for Securitization Positions CRD Article 122a: CEBS, Para. 4 (d) Solvency II and AIFMD (as above) 		
<p>Understand valuation methodologies of supporting collateral if appropriate</p> <ul style="list-style-type: none"> US Final Market Risk Capital Rule: Due Diligence Requirements for Securitization Positions CRD Article 122a: CEBS, Para. 4 (f) Solvency II and AIFMD (as above) 		
<p>Independence in deal and portfolio assessments</p> <ul style="list-style-type: none"> US Final Market Risk Capital Rule: Due Diligence Requirements for Securitization Positions CRD Article 122a: CEBS, Para. 4; 93 and 94 Solvency II and AIFMD (as above) 		

Consolidated operations for structured finance investments

Comprehensively analyze investments	Perform ongoing surveillance and risk management	Implement operational controls and timely reporting
<p>Know the risk characteristics</p> <ul style="list-style-type: none"> • Access and analyze asset specific risk characteristics for each and every securitization position e.g. tranche seniority level, cash flow profile, waterfall related triggers, historical performance of similar tranches, market value triggers or credit enhancements etc • Define and integrate the relevant bond level issuance information into deal by deal and portfolio wide analysis 	<p>Monitor, on an ongoing basis and in a timely manner, performance information on the exposures underlying securitization positions</p> <ul style="list-style-type: none"> • Identify, integrate and monitor the necessary asset specific performance statistics for each class of structured finance asset held • Comprehensively analyze deals and portfolios, querying the most relevant key performance indicators, e.g. % Loans 30/60 and 90 day past due, default, prepayment or foreclosure rates, frequency distribution of credit scores, loans in foreclosure, occupancy or other measures of credit worthiness • Perform this analysis across underlying exposures, industry sectors and geographical factors • Resecuritized: Monitor the risk characteristics and the performance statistics of the underlying securitized pools 	<p>Address regulatory due diligence, reporting and audit requirements now; ensure flexibility to evolve with changing requirements</p> <ul style="list-style-type: none"> • Implement a fully customizable and scalable infrastructure that is flexible enough to incorporate future regulations and growth • Implement standardized compliance and collateral performance and portfolio reports, as well as the ability to develop custom reports for: <ul style="list-style-type: none"> • Regulatory compliance e.g. Due diligence reports for positions within 3 days of acquisition, including issuer name and summary of risk characteristics • Monitoring ongoing asset performance • Operational compliance • Investment and risk compliance
<p>Risk characteristics of underlying exposures</p> <ul style="list-style-type: none"> • Determine the granularity of collateral analysis required e.g. collateral pool performance tables, pool stratifications statistics or, if necessary, loan level drill down • Access, organize and analyze the relevant historical deal performance data and collateral stratification detail necessary for each asset backed deal • Be able to access and analyze loan level information on a case by case basis if a true understanding of the deal demands it 		<p>Access and consolidate the management of all relevant securitization data (market pricing, deal issuance, collateral performance, or loan level) in a single operational environment. Draw in this data on-demand as appropriate for each asset, to perform due diligence in a timely and comprehensive manner.</p> <ul style="list-style-type: none"> • Standardized interfaces and consistent analysis of data from all internal and external sources • Consolidate multiple spreadsheets/systems/data sources spanning asset classes and business units
<p>Impact of structural features on a position</p> <ul style="list-style-type: none"> • Integrate and analyze accurate, sufficient waterfall models for every deal alongside details of triggers, swaps, liquidity facilities, reserve accounts, guarantees, sponsor support mechanisms etc 		<p>Streamline business-wide processes, eliminate spreadsheet reliance and ensure data integrity</p> <ul style="list-style-type: none"> • Consolidate multiple spreadsheets/systems spanning multiple deals, asset classes and business units • Consolidate analysis, risk oversight and operational controls across banking book, trading book and independently managed business units
<p>Reputation and loss experience of originator</p> <ul style="list-style-type: none"> • Highlight and query the performance history and reputation of an originator or sponsor by sector, geography or asset class, assessing internal trade information alongside external sources e.g. downgrade information, outstanding litigation details or past loss experience 		
<p>Originator or sponsor's net economic interest</p> <ul style="list-style-type: none"> • Verify that the minimum risk retention requirement has been met and recorded in your systems. Which of the retention requirement categories has been met? • If applicable, does the originator regularly update information regarding their economic interest and is this recorded? 		
<p>Valuations of supporting collateral</p> <ul style="list-style-type: none"> • Determine whether it is necessary to understand the valuation process behind any individual asset within the deal pool e.g. for non-granular CMBS assets • If so, verify and prove the independence of the valuer 	<p>Deal and portfolio wide risk surveillance, stress testing for independent assessments and comprehensive reporting</p> <ul style="list-style-type: none"> • Consolidated view of exposures to analyze by: <ul style="list-style-type: none"> • Business line; • Portfolio exposure parameters (e.g. concentrations by asset, sector, geography or ratings etc); • Performance exposures (e.g. delinquency, default, prepay, foreclosure etc) • All your structured finance assets, alongside your other fixed income assets, hedging derivatives and funding instruments • Evaluate all potential stresses on a position's cashflow and analyze whether risk of default is low and consistent with bonds of similar credit quality • Stress test valuation assumptions and perform scenario analysis based on your own views of future performance • Validate third party models and demonstrate understanding of methodologies, assumptions and results • Proactively monitor, report and pre-empt risks across the full range of required portfolio, deal, tranche or collateral metrics setting flags, triggers and limits to automate early warning signs and highlight exposures for further analysis. 	<p>Impose controls to establish business wide operational control. Implement and manage compliance guidelines and workflow processes within a fully auditable environment</p> <ul style="list-style-type: none"> • Review and update due diligence analysis on a quarterly basis • Make structured finance policies formal processes to analyze the investment book and prove due diligence activities across the business • Implement business-wide controls to maintain compliance with investment guidelines, risk profile and establish a formal trade workflow process • Implement and audit trade lifecycle paths from inception, through to credit approval and settlement
<p>Independence in deal and portfolio assessments</p> <ul style="list-style-type: none"> • Apply your own assumptions to third party cashflow models to forecast cashflows for any given security • Ensure risk assessments for all securitization positions are within your full responsibility and control; not a third party's 		