

Securitization: 10 risks to manage

Identify | Understand | Mitigate



Though asset securitization is one of the most complicated forms of financing, it continues to be a growing segment of the capital markets

Securitizations provide many unique benefits for participants. Among them are opportunities for corporate borrowers to monetize illiquid assets, reduce their cost of funding, transfer risk and create access to the capital markets. Investing in the resulting securities represents a means for investors to generate excess returns, diversify portfolios and invest in tranches that correspond to unique risk profiles.

The current market environment has been highly conducive to the formation of new securitizations. This trend is likely to continue. As the market grows, the complexity of this financing structure demands an appreciation and a thorough understanding of the risks by the business, management, internal auditors, and investors to properly identify, successfully manage, and mitigate risk exposures. In addition, issuers, investors, placement agents and other participants should understand these risks on an integrated basis. This group includes internal audit teams, which face their own challenges due to the unique nature of many securitizations.

Key inherent risks associated with a securitization

The principal risks associated with the life cycle of a securitization can be categorized into 10 general themes, each of which deserves serious consideration. Although the themes discussed in this document by no means represent all of the risks associated with securitization, they do encompass the principal risks that participants should keep in mind.

It should be noted that not all risks pertain to all parties in a securitization; however, all risks should be identified and understood. While certain risks may not affect a participant at the onset of a transaction, other risks may arise given the performance of the transaction and the role assumed by the party. It is critical for each party to understand the relevant risks and integrate them into their risk management framework.

Who are the key parties in a securitization?

- Asset managers
- Backup servicers
- Collateral agents
- Custodians
- Interim managers
- Investors
- Nationally recognized statistical rating organizations (NRSROs)
- Obligor
- Originators/Sellers
- Placement agents
- Servicers
- Special purpose entities (SPEs)
- Trustees
- Underwriters

Key risk themes



Credit risk

While the underlying credit worthiness of a securitization affects all participants, credit risk should be of concern to originators, servicers and investors. Evaluating credit risk involves an analysis of the underlying asset class, the performance of due diligence of the underwriting process, a review of the historical payment performance of similar obligors and a projection of the probability of default. Mechanisms to evaluate credit risk include appropriate pricing of the bonds as well as the inclusion within the underlying documentation of remedies to reduce credit risk.



Liquidity risk

Although related to credit risk, liquidity risk needs to be evaluated and managed separately. Securitizations are initially structured to provide sufficient liquidity for the SPE by ensuring that incoming and outgoing payments are matched. Liquidity risk occurs when incoming and outgoing payments are mismatched due to a variety of factors, including early or late repayments to debtors, underlying asset defaults or lack of reinvestable assets. Should payments in and out of the SPE become mismatched, a potential liquidity issue could arise. Liquidity risk can be reduced by performing appropriate due diligence when creating the securitization. This can take the form of cash flow modeling, stress testing and credit analysis that can help to address and minimize this risk.



Regulatory compliance risk

After the 2008 global financial crisis, U.S. regulators revised existing regulations and developed new regulations for securitizations. These changes served to make securitizations more transparent, increase asset-level data availability, highlight potential conflicts of interest, align investor and manager interests, and encourage independence of the NRSROs. The principal U.S. regulatory considerations surrounding securitizations are:

Regulation AB: Asset-Backed Securities Disclosure and Registration

In April 2010, Regulation AB was revised to enhance transparency, improve investor protection and restore confidence in the ABS market. The final rules are intended to (i) present investors with timely and sufficient information, (ii) reduce undue reliance on credit ratings and (iii) provide mechanisms to help enforce representations and warranties made about the underlying assets.

The Regulation AB revisions changed (i) asset-level data requirements, (ii) shelf-registration eligibility requirements, (iii) dispute resolution mechanisms within transaction agreements, (iv) form and filing timeliness and (v) prefunding levels from 50% to 25%.

SEC Rule 17G: Conflicts of interest

In December 2009, this rule was amended to impose additional disclosure and conflicts of interest requirements on NRSROs, issuers, sponsors and underwriters. The changes were prompted by “ratings shopping” concerns. The rule is intended to encourage unsolicited ratings by nonhired NRSROs.

The Dodd-Frank Wall Street Reform and Consumer Protection Act

The principal impact of the Dodd-Frank legislation on securitizations was upon (i) risk-retention requirements for sellers (no longer applicable to collateralized loan obligations [CLOs] or applicable qualified residential mortgages) and (ii) credit rating agency reforms. Credit agency reforms are intended to enhance governance, protect against conflicts of interest and increase transparency. The goal of the Dodd-Frank legislation was to further improve the quality of credit ratings and increase credit rating agency accountability.



Servicer performance risk

Within a securitization, the servicer’s responsibilities include (i) the collection of principal and interest, (ii) customer support and payment processing and (iii) default management, collateral liquidation and investor report preparation. Servicer performance risk arises when the servicer is unable to meet these requirements. This can occur for a variety of reasons, including:

- **Servicer credit risk:** A significant degradation in the credit profile of the servicer due to bankruptcy or other means could cause the servicer to be unable to meet some of its key functions, particularly those related to shortfall payments to holders of notes/bonds and payments required to maintain real estate collateral. A distressed or bankrupt servicer may not have the ability to advance funds, resulting in a payment or technical default by the SPE.
- **Performance risk:** Servicers are obligated to provide accurate and timely investor reports. Inaccurate or delayed investor reporting — including the failure to report losses — could trigger a technical default of the securitization.
- **Operations:** Servicers must continuously maintain data integrity, update technology platforms for scalability, provide for privacy protection with appropriate cybersecurity, and have proper administrative capabilities, including properly handling the ongoing management and collection of the receivables of the underlying assets.
- **Compliance:** Servicers are subject to various regulatory, legal and compliance obligations. A servicer’s risk management and compliance management functions must be robust to ensure compliance.

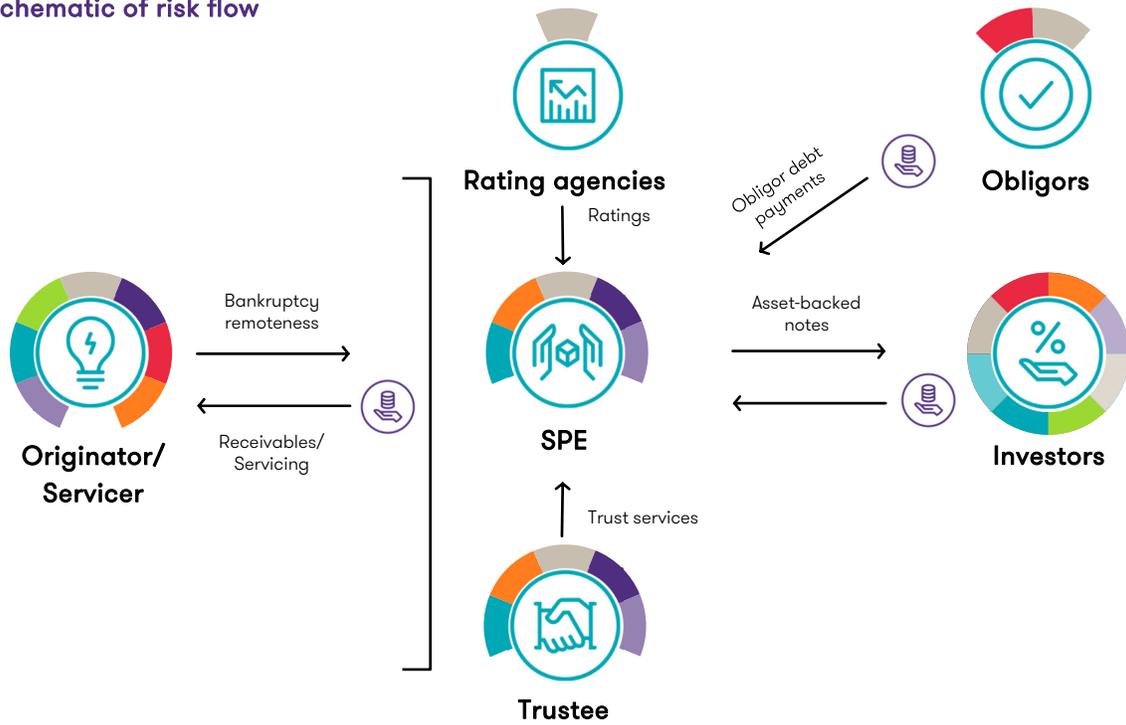
Having a reliable servicer is crucial, given that replacing one leads to added risks from potential disruption in cash flow and data integrity, to increased costs associated with the transfer of responsibilities and the learning curves for the new servicer.



Mapping the 10 risks faced by the main participants

For a better understanding of the 10 types of risks each participant faces in a securitization, the following illustrative schematic maps the risks to the relevant party.

Illustrative schematic of risk flow



Types of risk	Originator	Trustee	Obligor	Servicer	SPE	Investors	Rating agency
Servicer performance							
Interest rate & prepayment							
Liquidity/Market							
Counterparty							
Risk of downgrade							
Legal							
Credit							
Operational							
Rating methodology							
Guarantor							



Risk of a downgrade

The possibility of a rating agency downgrade also represents a significant risk to participants of a securitization. Downgrade risk can affect not only the obligors' ratings, but also the ratings of the liabilities of the SPE, trustee or servicer. Downgrades of securities can render that security ineligible for CLO investors and/or reduce the market price/value of a security. This can have an impact on an investor's balance sheet or trigger an early wind-down event.

Obligor downgrades can affect the SPE's asset coverage, while a trustee or servicer downgrade can disqualify that institution or trigger a servicer transition. For each one of these events, it is critical to understand what remedies can be taken and how best to address the risk. Downgrade risk can be mitigated through rigorous due diligence on underlying assets and liabilities. In addition, appropriate documentation would allow for the replacement of the trustee or servicer in the event that the trustee or servicer is deemed ineligible due to a downgrade.



Interest rate and prepayment risk

Securitizations are sensitive to changing interest rates, with every aspect of a securitization being affected. Similar to downgrade risk, a movement in interest rates can affect the price of a security, which may have a detrimental effect on the balance sheets of investors. Within the SPE, a sharp rise in interest rates can lead to increased defaults for obligors as debt becomes more expensive to service.

Interest rate risk can also lead to prepayment risk. This occurs when changes in interest rates trigger prepayments, which has the potential to lower the future cash flows supporting the transaction. This happens when the SPE is unable to find assets with characteristics similar to the assets that were prepaid.

Interest rate and prepayment risk can be addressed in multiple ways, including structural credit enhancements and interest rate swaps.



Counterparty risk

As in any financial transaction, securitizations carry the risk of default or nonpayment from counterparties. Specifically, SPEs face risk from their obligors, interest rates and other hedging counterparties. In turn, the trustee, servicer and originator all assume this risk, given their respective relationships with the SPE. In evaluating counterparty risk, participants should consider the credit quality/ratings of any counterparty, its historical behavior and experience.



Ratings methodology risk

Securities are typically rated by NRSROs using their marketplace expertise, data and modeling skills. Factors that go into an NRSRO review include the quality of the asset pool, repayment ability, maturity, diversification, expected defaults, recovery rates, servicer quality, overall structure, timing of cash flows, defaults, legal review, quality of the asset manager, and the forms and levels of credit enhancement.

If an NRSRO were to change its rating methodology, the SPE's securities and/or assets could be impacted by a change in the value, liquidity or eligibility of the SPE's securities. In August 2017, the SEC adopted new requirements for credit rating agencies to enhance governance, protect against conflicts of interest, and increase transparency to improve the quality of credit ratings and increase credit rating agency accountability. As part of these controls, NRSROs are required to disclose new or updated methodologies to the public for consultation prior to implementation.



Operations risk

The active management of the SPE encompasses many operational risks. These include, but are not limited to, the investment process; people quality; reporting requirements; business resiliency; fraud, cyber and data safeguards; and third-party risk. Strong underwriting processes can enhance the quality of the assets, while deficient processes can result in lower-quality assets within the SPE. Internal information systems and risk control processes help to mitigate operational risk.



Legal review risk

Legal review risk arises from the documentation surrounding the structure, requirements, processes and remedies within a securitization. Non-standardized contract language for securitization agreements can create increased exposure to addressable risks, including liquidity, legal and reputational risks. Underlying documentation will need to contemplate both the issues that can occur and potential remedies for those issues. Documentation should also provide flexibility via mechanisms for addressing unanticipated problems that can occur.

For example, the impending replacement of LIBOR may cause operational interruptions or basis risk between the underlying assets and liabilities of a securitization that does not contemplate the replacement of LIBOR. Securitizations that have properly considered a fallback rate, or provided mechanisms for replacement, will be able to manage this transition more successfully than those that have not.

To reduce legal review risk, the value of strong and thorough counsel cannot be overstated. Verification of all documents helps ensure more than legal and regulatory compliance. It provides a framework of enforceability for non-compliance that can protect all participants.

A unique risk: Whole business/future flow

Both whole-business and future-flow securitization transactions have a unique but important executory risk that must be considered and managed by transaction participants. In a whole-business securitization, a company pledges its revenue-generating assets (nonfinancial assets) to an SPE. Typically, this is composed of the entire operating assets of the company. In a future-flow securitization, expected future flows are used as the mechanism to pay the SPE's principal and interest. The ability to service debt is dependent upon future receivables and collection of those receivables.

These types of securitizations are dependent upon the continued operations of the underlying business. Executory risk, risk that the business remains operational and "executes" its business model to generate cash flow, is unique to a securitization that is composed of operating assets as opposed to financial assets. Appropriate due diligence and credit analysis of the underlying operating business will help to mitigate this risk.

Due diligence: A risk mitigator

To comply with due diligence requirements, arrangers/underwriters of securitization transactions hire qualified professionals to perform certain procedures that involve accessing the originator's books, records and files to test the information on the originator's system against the information in the offering materials.

Due diligence requirements include:

- **Corporate:** Evaluation of whether a company fits an acceptable customer profile.
- **Credit:** Assessment of the sustainability of a deal, even in situations where borrowers are under financial stress.
- **Legal:** The compiling and reviewing of relevant legal documentation to ensure legal and regulatory compliance, and enforceability if contested.
- **Regulatory:** Review of securitization to ensure compliance with Form ABS Due Diligence 15G and 15E, SEC Rule 17G-5, and risk retention rules.
- **Assets:** Compare characteristics of assets held by the securitization to underlying source documentation.
- **Collateral stratification analysis:** Analyze the disclosures in offering materials to ensure that the asset pool is appropriately segmented according to various criteria.
- **Cash flow modeling:** Recompute projected cash flows disclosed in offering material disclosures (bond analytics) under various scenarios to evaluate riskiness of securitization.
- **Offering documents:** Compare other disclosures to asset information.

Prudent risk management and controls

When it comes to structuring a successful securitization, understanding where risk resides with respect to each party helps identify the tactics necessary to install proper controls for managing that risk. This process takes a strong partner with a depth of front-line experience within the industry, and specifically in the evaluation of securitization deals through all stages of a structured product life cycle.

In addition to creating a risk management framework, as discussed earlier, all securitization participants should be thinking about how specific duties addressing these risks should be assigned and coordinated within their respective organizations.

The 'Three Lines of Defense'

The "Three Lines of Defense" model provides a simple and effective way to enhance communications on risk management and control by defining specific duties and roles for each participant. The first line of defense is "Operational Management." The group that owns the business function (i.e., securitization group) is assigned the management of its specific risks. The second line of defense is the implementation of "Risk Management and Compliance Functions." This requires identifying where within the organization teams can help build and/or monitor the controls implemented by the first line. Finally, the third line of defense is the use of an independent "Internal Audit" department to provide assurance on the effectiveness of governance, risk management and internal controls.

Chief among processes to mitigate risk are appropriate due diligence, robust risk management and an appropriate controls framework. Taken collectively, these will help all parties to properly identify and address their specific applicable risks.

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