IN THE FIRST OF A THREE-PART SERIES ON SECURITISATION, **DAN KEEBLE** AND **MICHELLE MITCHELL** ANALYSE THE MOTIVATION BEHIND DUE DILIGENCE.

To build a reputation

Executive summary

- Asset due diligence involves ensuring information about the asset pool is consistent with the underlying assets; rating agency due diligence is about ensuring the deal is sustainable; legal due diligence concentrates on compiling and reviewing relevant legal documentation.

The securitisation market in Europe has evolved significantly since the first transactions in the 1980s. It is now an extensively used widespread financing tool. Strong investor demand fuelled by attractive relative spreads and the need for further diversification has led to the expectation of significant future growth. Collateralised debt obligations and commercial mortgage-backed securitisation are particular niches experiencing the highest growth, and the trend is expected to continue over the near future.

This article looks at asset due diligence, rating agency due diligence and legal due diligence (the most common forms of due diligence) and analyses the motivation behind each.

WHAT IS MEANT BY DUE DILIGENCE? In the traditional sense of the phrase, due diligence can be defined, in the context of securitisation, as a process to ensure that the information provided to the market about the transaction is consistent with the underlying assets. The work takes the form of agreed procedures.

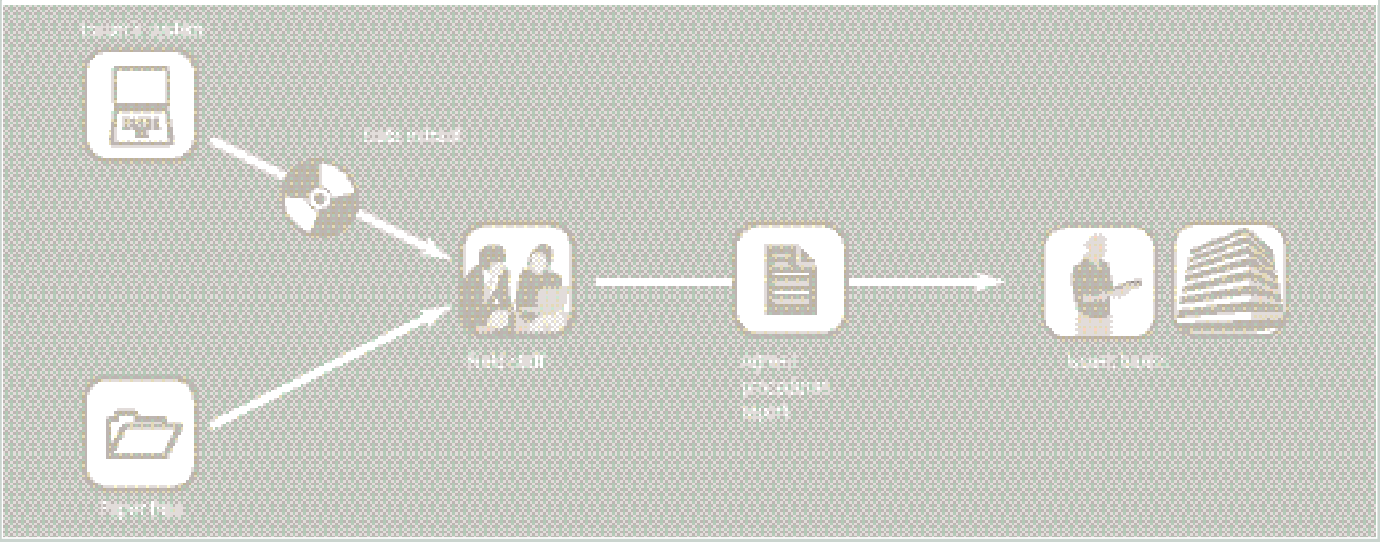
It is industry practice for due diligence to be carried out on the relevant asset pool or a sample of it. Misleading information about collateral can have a big impact on the deal, such as leading the originator to include warranties to guarantee pool performance.

First-time issuers can expect to have to perform a much deeper level of due diligence than established issuers, who have a proven record. As originators become more comfortable with the due diligence process, controls are implemented to prevent or detect inaccurate data in the normal course of business, which causes the number of reported exceptions to fall. This should be the general aim of all originators planning to securitise at some point in the future.

ASSET DUE DILIGENCE Originators are placing greater emphasis on asset due diligence, requiring broader and more detailed work by the transaction parties. Asset due diligence aims to verify the consistency and accuracy of data held by originators about the assets intended to be securitised. The second stage is to confirm that the information offered to the investors in the offering circular is accurate and consistent with the underlying source of documentation.

Due diligence work is generally performed immediately prior to the execution of a transaction but can be performed on an ongoing basis as assets are originated. This process is summarised in *Figure 1*. A hypothesis is set out at initiation with a number of tests to be carried out on either the entire population or a sample depending on a number of assets in the deal. The originator must communicate with the various interested parties to decide which attributes will be verified. These elements to be confirmed are restricted only by the types of data stored by the originator on its system. See *Box 1* for the

Figure 1. The process of due diligence



minimum attributes that need to be tested for a typical residential mortgage-backed security (RMBS) deal.

The agreed procedures report will list all exceptions identified on an attribute-by-attribute basis – that is, those sampled assets found not to be in agreement with the relevant source information. First-time issuers commonly report a relatively high number of exceptions.

The major difficulty is that there is no standard approach which can be used for all issuers, nor are there standard data field definitions. Every issuer and every deal is unique and as such the requirements differ across cases. It is important to understand fully the business process in place at the asset processing service provider. In all cases, clear and effective communication between all relevant parties is vital to ensure the timely completion of the necessary work.

RATING AGENCY DUE DILIGENCE Whereas asset due diligence is mainly concerned with making sure the information about the asset pool is consistent with the underlying assets, rating agency due diligence is concerned with making sure the deal is sustainable. Any or all of the three main rating agencies will analyse the deal from the credit risk perspective and assign a relevant level of credit enhancement to protect note holders at every level from default. The objective of each structure, from the originator's perspective, is to maximise AAA class and minimise subordinated notes and cash reserve as credit enhancement to superior classes.

Even though methodologies used by different rating agencies vary significantly, the process can be broadly summarised as follows:

- Collateral credit analysis (standard loan level analysis);
- Liquidity analysis (analysing credit stress effect on note amortisation);
- Legal analysis (structure and terms of notes analysis); and
- Originator and servicer due diligence.

The process of rating agency due diligence concentrates on getting to know the originator as the underwriter and servicer of assets with the focus on policies, procedures and quality controls in place from the cradle to the grave of the asset. The process may involve a presentation which could cover underwriting and servicing methods, and historic performances, and would typically be followed up by meetings with underwriters themselves and a review of a small sample of the pool.

The documentation required by rating agencies as an illustration of company practice will also differ mainly depending on the type of business and assets.

At the initial stage the originator should be prepared to provide company and business line information to give a complete picture of the function in question.

Once a rating agency has obtained a company overview, the focus will fall on loan level analysis. This may include lending process evaluation, credit scoring and valuation procedures, loan characteristics including loan to value ratio, loan size limits, average loan size and interest rates information. Application forms and offer letters, loan insurance requirements and borrower information with particular focus on self-certification will also be required.

Last but not least, company IT systems, both software and hardware functionality and efficiency, may draw the attention of the agency analysts.

Rating agency due diligence seems like a daunting task, but the process becomes relatively straightforward with subsequent issuances as the originator and the rating agencies become more comfortable with each other.

LEGAL DUE DILIGENCE The level of legal focus would be formalised between the originator and the appointed company and may largely depend on the ability of the originator to carry out in-house legal due diligence. The starting point of legal due diligence would be compiling the following documentation:

- Constitutional documents, including articles and memoranda of association;
- Annual reports for the last three to five years;
- Any relevant information regarding membership rights;
- Policies and procedures in relation to loan origination and underwriting;
- Policies and procedures in relation to loan servicing/delinquencies and defaults;
- Third-party IT contracts if relevant;
- Loan application forms;
- Offer letters; and
- Example of loan contracts (terms and conditions).

BOX 1: MINIMUM ATTRIBUTES FOR RMBS

- Borrower names
- Property address
- Original advance
- Original term
- Report on title signature
- Property tenure
- Valuation amount
- Valuation date
- Valuation signature
- Current balance

This can further extend to:

- Completion date
- Bankruptcy/Individual Voluntary Arrangement flag
- Count of County Court Judgements (CCJs) (satisfied)
- Last CCJ date (satisfied)
- Value of CCJs (satisfied)
- Count of CCJs (unsatisfied)
- Last CCJ date (unsatisfied)
- Value of CCJs (unsatisfied)
- Arrears in months
- Borrowers' income
- First-time buyer flag
- Right-to-buy flag
- Buy-to-let flag
- Self-cert status

The purpose of legal due diligence can vary depending on the needs of the originator but will generally involve a review of the following areas:

- Background and history of the company;
- Management structure;
- Operational issues;
- Loan products;
- Collateral origination;
- Servicing; and
- Legal and regulatory considerations.

THE CORRECT PROCESS The rationale behind the due diligence process is to build up the originator's reputation as a reliable and trustworthy source of information.

Investors are becoming more sophisticated as the market develops. They are increasingly performing their own due diligence and this trend is expected to continue. Requests for specific loan-level data suggest that investors are developing their own models and stress-testing the data accordingly. This appetite for more data is also being reflected in the investor post-close reporting requirements.

This is the first of a three-part series on securitisation. Other issues to be covered include accounting, finance and tax issues and whole business securitisations.

Dan Keeble is Director and Michelle Mitchell is Senior Manager, Treasury Consulting and Audit, at Deloitte.
dkeeble@deloitte.co.uk
michellemitchell@deloitte.co.uk
www.deloitte.co.uk/securitisation