

Methodology

*Operational Risk Assessment for
European ABS and SME CLO Servicers*

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Introduction

DBRS operational risk assessment procedures for European Asset-Backed Securities (ABS) and small- and medium-sized enterprise loan collateralised loan obligation (SME CLO) servicers are designed to evaluate the quality of the parties that service or conduct backup servicing on the loans (or leases as applicable) that are about to be securitised or have previously been securitised in a transaction to be rated by DBRS. While DBRS does not assign formal ratings to these processes, it does conduct operational risk reviews to determine if a servicer is acceptable and incorporates the results of the review into the rating process for new transactions and into the surveillance process for outstanding transactions rated by DBRS. It should be noted that DBRS recognises that there are different rules, regulations and practices for each jurisdiction in Europe and as such tailors its approach as applicable.

DBRS begins the initial servicer review process by scheduling a date to conduct an on-site visit of the company. Once a date is confirmed, DBRS sends a sample agenda that outlines the topics to be covered during the meeting which includes a list of documents to be provided such as organisational charts, financial statements and performance statistics (Appendices 1-6). During the on-site review, DBRS meets with senior management and, if deemed necessary, operational staff to discuss the servicing operations, tour the facilities and review system demonstrations, as appropriate. The on-site review typically takes one to two days, depending on the product(s) being serviced and number of servicing sites. DBRS assesses the information gathered through the review process, along with its surveillance data and industry statistics to determine if a servicer is acceptable. In instances where DBRS determines that the servicer is below average, issuers may incorporate certain structural enhancements into a proposed transaction such as additional credit support, dynamic triggers or the presence of a warm or hot backup servicer in order for DBRS to be able to rate the transaction.

DBRS conducts periodic reviews of the servicer as part of the ongoing monitoring of outstanding transactions or in cases when unexpected events warrant such as the sale of the operation, a material change in ownership or bankruptcy of the servicer. The reviews are intended to inform DBRS of any changes that have taken place since the last operational risk review, especially any material changes to the operation or its management. The review may be accomplished through a conference call, meeting with senior management or by an on-site visit to the servicer. The type of review needed is typically determined based on the length of time since the last on-site review, the performance of the rated transactions and the materiality of any changes within the organisation. Any findings from the update review are incorporated into the surveillance process in addition to being included in the analysis for new transactions.

In cases when the servicer or its parent is publicly or privately rated or internally assessed by DBRS at below investment grade or if DBRS believes that, while not imminent, there is a risk that the servicing may need to be transferred at a future date, issuers may incorporate a warm backup servicer as a transaction party. Some reasons for the inclusion of a warm backup servicer could be: the company is up for sale, senior management recently departed, lines of credit were not renewed or now have more restrictive covenants, or delinquency levels are trending upward and there is concern about potentially hitting servicing transfer triggers in a transaction. Certain reasons for the inclusion of a hot backup servicer could be: if a servicer is relatively new to the servicing business, lacks experience servicing the product being securitised, has a limited number of loans in its portfolio or the servicer or its parent is a below investment grade rated entity. In the event that DBRS determines that a servicer is unacceptable, it may refuse to rate the deal.



Servicer Review Process

The servicer review process typically involves an analysis of the following:

1. Company and Management
2. Financial Condition
3. Loan Administration
4. Customer Service
5. Account Maintenance
6. Default Management
 - Collections
 - Loss Mitigation
 - Bankruptcy
 - Fraud
7. Investor Reporting
8. Technology

COMPANY AND MANAGEMENT

DBRS believes that no servicing operation can be successful without a strong seasoned management team that possesses demonstrated expertise in the product(s) they are servicing. As a result, DBRS views favourably those servicers whose management team possesses greater than ten years of specific industry experience. Furthermore, adequate capacity and resources to handle fluctuations in loan volume are of paramount importance.

DBRS also believes internal assessments and quality-control reviews are critical in recognising procedural errors that may not be easily detectable. These reviews can be used to identify trends, training opportunities and exception practices. Frequent checks can assist management in quickly instituting changes to areas needing improvement. In addition to the aforementioned reviews, a monitoring process should be in place to ensure that the servicer is in compliance with all applicable laws, rules and regulations and that all employees in borrower-facing positions are appropriately trained.

FINANCIAL CONDITION

DBRS reviews the servicer's financial condition to determine whether the servicer has sufficient resources and to assess the likelihood of a servicing transfer, servicer bankruptcy or other potential interruption in cash flow to a transaction.

In cases where DBRS does not maintain a public or private rating of the entity performing a servicing role, the DBRS Financial Institutions Group provides an internal assessment (IA) of the relevant institution. The IA is monitored over the life of the transaction and DBRS will notify the relevant institution of the internal assessment and when the internal assessment is changed. In certain cases, DBRS may rely on public ratings assigned and monitored by other credit rating agencies.

Some items that are reviewed as part of this process may include:

- Company ownership structure
- Management experience
- Corporate rating of any parent company (if applicable)
- Internal and external audit results
- Revenue sources including servicing fees and lines of credit
- Costs to service
- Litigation (past, present and expected)
- Existing business strategy and strategic initiatives
- Recent or planned mergers or acquisitions



- Recent or planned transfer of servicing rights
- Securitisation history and future plans

Any financial stress identified can elicit servicing problems either immediately, as in the case of a servicer bankruptcy, or lead to a slow degradation of the performance of the collateral. Therefore, the servicer's financial condition weighs on all aspects of DBRS analysis of ABS and SME CLO transactions including the evaluation of proposed credit enhancement levels and the presence of proposed minimum structural safeguards.

LOAN ADMINISTRATION

DBRS reviews the loan administration area to assess servicers' loan booking accuracy, data integrity, application of payments to borrower accounts and exception rates. Servicers with large numbers of un-reconciled items indicate a fundamental problem with the cash management operation. As a result, DBRS views favourably those servicers with a high level of automation and a low tolerance for un-applied funds. Additionally, DBRS reviews the servicer's efforts towards compliance with regulatory guidelines and industry best practices. Furthermore, the servicer's portfolio is reviewed for changes in size, product type or delinquency to determine if more frequent reviews or management calls might be necessary to monitor the performance of the portfolio.

CUSTOMER SERVICE

DBRS reviews the customer service area to see how well the servicer responds to borrower inquiries. Performance metrics such as call hold times and abandonment rates are reviewed to determine if the department is appropriately staffed or if certain call blockage features are in place to prevent borrowers from being able to speak to a representative. Strong account management processes are highly important to retaining good-quality accounts and avoiding attrition in addition to preventing delinquencies. Furthermore, a monitoring process should be in place to ensure that the servicer is in compliance with all applicable laws, rules and regulations and that all employees in customer-facing positions are appropriately trained.

DEFAULT MANAGEMENT

The effectiveness of a servicer's operation has a direct impact on security performance and ultimately losses to the ABS or SME CLO investor. A servicer's strategy for handling loans in default can stabilise or improve pool performance. The marketing of repossessed assets, as well as ultimate disposition timelines and cost containment, can also determine a servicer's performance.

A limited number of servicers use predictive dialer systems that incorporate behavioural scores to identify and prioritise the riskiest borrowers. Collection efforts generally escalate in intensity as accounts roll to more advanced delinquency categories. Depending on the stage of delinquency, the servicer may offer repayment plans, extensions or deferrals to help the account become current. DBRS views favourably those servicers that have predictable performance and strong monitoring procedures for delinquent accounts. Once an account becomes delinquent, effective collection procedures can minimise losses to investors. Accordingly, DBRS evaluates the quality of the collections strategy and staff in order to determine their success rates in contacting borrowers and determining their ability and willingness to pay.

Additionally, a servicer's ability to prevent and manage fraud is reviewed to determine the precautions utilised to detect such activity. Fraud risk varies across jurisdictions and asset types and in certain instances DBRS believes this area is vital to maintaining a successful operation and therefore expects servicers to have formal processes surrounding fraud that are communicated regularly to staff and to employ experts to continuously update prevention strategies.

INVESTOR REPORTING

DBRS reviews the investor reporting function to see if they have a track record of timely and accurate remittances to trustees and/or master servicers. Consequently, DBRS views favourably those servicers who have never had to restate a remittance report and have strong controls over data integrity.



TECHNOLOGY

Technology resources are an integral component of the servicer review process. While DBRS does not opine on the relative merits of specific systems architecture, adequate systems controls, consumer privacy protection and backup procedures, including disaster recovery and business continuity plans, are considered critical processes. Furthermore, DBRS reviews back-up arrangements for any third party service providers or suppliers. Over the past few years, the Internet has enabled many firms to operate effectively in the ABS business. Servicers have used the Internet for marketing, customer service and the dissemination of pertinent information, such as payment reminders or inquiries relating to repayment plans, restatements or payoffs. As a result, DBRS expects servicers to have the appropriate staff and controls in place to ensure website availability, account maintenance and enhancements. Sophisticated technology, with robust functionality, is viewed favourably by DBRS as it often helps bring large efficiencies to the servicing operations in addition to more predictability in terms of performance.

MASTER SERVICER

Master servicers are uncommon in Europe. A master servicer is responsible for collecting loan data from primary servicers, calculating the expected principal and interest payments that should be remitted and reconciling any differences with the servicers. Additionally, master servicers need to report and remit funds timely and accurately to the issuer.

SPECIAL SERVICER

Where employed in an ABS transaction, a special servicer is tasked with returning delinquent loans to a performing status or quickly disposing of loans that are non-performing. As a result, DBRS places particular emphasis on the years of experience and default management expertise of the special servicers. Of significant importance is the ability of the servicer to manage delinquency roll rates, offer effective workouts and minimise recidivism rates. DBRS views favourably those servicers that employ sophisticated decision-making software to facilitate and track the loss mitigation process. Furthermore, a special servicer's ability to quickly liquidate assets at acceptable loss severities is paramount.

BACKUP SERVICER

There is no consistent definition of warm and hot back-up servicing arrangements across Europe. DBRS generally defines the two as follows:

Warm Backup Servicer

A warm backup servicer is responsible for performing all of the activities necessary to ensure that in the event of a default or bankruptcy of the current servicer it would be able to take over all of the primary servicing responsibilities outlined in the servicing agreement within a short period of time (typically 30-120 days). In an effort to prepare for the transfer, the warm backup servicer typically conducts an on-site visit of the company, maps all of the data fields to their servicing system and receives monthly data tapes of the transactions to ensure minimal downtime.

Hot Backup Servicer

A hot backup servicer is responsible for performing all of the activities necessary to ensure that in the event of a default or bankruptcy of the current servicer it would be able to immediately take over all of the primary servicing responsibilities outlined in the servicing agreement. In an effort to prepare for the transfer, the hot backup servicer typically conducts an on-site visit of the company, maps all of the data fields to their servicing system and receives daily/monthly data tapes of the transactions to ensure minimal downtime. The hot back up servicer is also responsible for tying out with the servicer on all remittance/investor reports to ensure they are accurate in addition to monitoring the on-going performance of the servicer.



Conclusion

DBRS recognises that servicer performance is a key component in rating ABS and SME CLO transactions and conducting appropriate surveillance. As a result, DBRS continues to refine and adjust its operational risk assessment procedures for European servicers, as necessary, in an effort to incorporate any changes or issues that arise in the marketplace. As noted above, DBRS does not assign formal ratings to these processes; however, it does consider the results of its reviews as part of the rating and surveillance processes.

Appendices

The appendices 1 to 6 contain a list of items typically relevant to DBRS review of servicers. Appendix 1 is general and applies to all ABS and SME CLO servicer reviews. The subsequent appendices contain additional items applicable to some ABS or SME CLO servicers. Several of these additional appendices may be applicable to a given servicer.



Appendix 1: Operational Risk Agenda for European ABS and SME Loan Servicers

SERVICER REVIEW PROCESS

DBRS servicer review process for European ABS and SME loan and lease¹ servicers typically involves an analysis of the company and management, loan administration, customer service, collections and loss mitigation, investor reporting and technology processes. Listed below are some of the items that may be reviewed as part of the servicer evaluation.

Company and Management

- Company history, ownership and operating experience.
- Financial condition/profitability.
- Management experience.
- Staffing, training and retention rates.
- Portfolio size and composition.
- Strategic initiatives.
- Competition.
- Litigation (past, present and expected).
- Description of any termination of ABS servicing mandate.
- Recent or planned mergers or acquisitions.
- Recent or planned transfer of servicing (rights), if any.
- Serviced portfolio runoff rates.
- Internal and external audit results.
- Efforts to ensure regulatory compliance (discuss any findings).
- Securitisation history and future plans.
- Third party outsourcing/servicing arrangements (if applicable).
- Vintage loss performance and trends to date.

Loan Administration

- New loan booking process.
- Procedures for checking booking accuracy and data integrity.
- Cash management procedures and controls.
- Payment processing and controls.
- Account reconciliation and timing.
- Exception and reconciliation failure management.
- Post-closing quality reviews.
- Approach to fraud detection.

Customer Service

- Procedures for responding to customer inquiries.
- Strategy and technology.
- Call volume and average time to answer.
- Number of representatives and ratio to call volume.
- Level of call blockage, if any.
- Response times for inquiries.

Collections

- Collection strategies for early-, middle- and late-stage collections.
- Explanation of call and notice cycles by product type.

1. In these appendices references to loans should be understood as references to both loans and leases where the context permits.



- Early warning indicators of distressed performance (for SME)
- Procedures for distressed accounts (for SME)
- Account-to-collector ratio.
- Right-party contact rate.
- Hold time and abandonment rates.
- Use of credit and behavioural scoring and other technology.
- Policies regarding extensions, deferrals or payment holidays.
- Use of collection agencies.
- Procedures for filing against bankrupt accounts (SME)
- Use of internal or external counsel for bankruptcies (SME)
- Write-off policies and process.
- Use of technology.
- Recovery performance to date.

Investor Reporting

- Procedures for dissemination of reports to investors and trustees.
- Average number of investors remitted to on a monthly basis (last 12 months).
- Average balance of monthly remittances (last 12 months).
- Number of late remittances in the last 12 months.
- Are accounts commingled? If so, how long?

Technology

- Core servicing system strengths and weaknesses.
- Capacity remaining in the servicing system.
- Web site availability, usage and security.
- Procedures for vendor selection and oversight.
- Disaster recovery/business continuity plans and success of last test.
- Frequency of full-system backup.
- Future initiatives.



Appendix 2: Additional Operational Risk Agenda Items for European Secured Loan and Lease Servicers

Remarketing/Loss Mitigation

- Repossession/enforcement timelines
- Describe remarketing procedures.
- Use of auctions, brokers or dealers to sell repossessed assets.
- Recovery rates.
- Filing and pursuit of deficiency judgments.



Appendix 3: Additional Operational Risk Agenda Items for European Servicers of Leases with Residual Value Exposure

Company and Management

- Percent of company's net worth made up of unrealised residuals.
- Funding facilities.
- Overview of your industry and how it has changed over the last five years.
- Residual value policies and procedures.

Lease Administration

- What are the terms of the lease for each asset type?
- Are any leases with affiliates of the lessor?
- Provide concentrations for top 20 lease types, lessors and vendors.
- What is the estimated useful life for each asset?
- Term of leases (include payment type i.e. fixed rate or balloon).
- Describe end of lease options available to the lessees.
- When does a delinquent lease stop accruing interest?
- Recourse versus non-recourse lenders.
- Describe collateral tracking

Collections

- Residual value performance and turn-in rates and trends.

Remarketing/Loss Mitigation

- Repossession/enforcement timelines
- Describe remarketing procedures.
- Use of auctions, brokers or dealers to sell repossessed vehicles/assets.
- Recovery rates by asset type.
- Vehicle maintenance, mileage and excess wear/tear recoveries (for autos).
- Filing and pursuit of deficiency judgments.
- Approach to fraud detection.



Appendix 4: Additional Operational Risk Agenda Items for European Auto Loan and Lease Servicers

Dealer Management

- Describe the process for evaluating relationships with dealers.
- On-going dealer oversight and management.
- Describe methods used to prevent and detect dealer fraud.
- Method and timing of payment to dealers.
- First payment defaults, delinquencies and repossessions by dealer.
- Are dealer's manufacturer-franchised dealers or independent? Covering new-, new- and used- or used-car-only dealers?
- How do you validate the information received from the dealers?

Loan Administration

- Describe collateral/title/insurance tracking.



Appendix 5: Additional Operational Risk Agenda Items for European Wholesale Auto Loan Servicers

Company and Management

- Historical repayment rate.
- Describe relationship between manufacturing organisation and the servicer.
- Outline payment terms and repurchase agreements, if any.

Dealer Management

- Describe the process for evaluating relationships with dealers.
- On-going dealer oversight and management.
- Provide risk ranking of current dealer base.
- Describe methods used to prevent and detect dealer fraud.
- Method and timing of payment to dealers.
- Delinquencies and repossessions by dealer.
- How do you validate the information received from the dealers?
- Procedures for monitoring dealer credit lines and locations.
- Insurance requirements for dealers.

Loan Administration

- Describe collateral/title/insurance tracking.



Appendix 6: Additional Operational Risk Agenda Items for European Credit Card Servicers

In the context of a review of a credit card servicer, references in Appendix 1 to loans should be understood as references to credit card accounts.

Customer Service

- Retention strategies.
- Policies regarding line increases.
- Over-limit fees and procedures.

Collections

- Policies regarding freezing or lowering credit lines and increasing annual percentage rates.
- Delinquency, roll and cure rates.

Loss Mitigation

- Significant changes (past or planned) in procedures or emphasis regarding workout strategies or timelines.
- Settlement practices.
- Procedures for handling accounts that declare bankruptcy.
- Write-off process.
- Filing and pursuit of deficiency judgments.
- Use of credit counsellors.
- Recovery rates.

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