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METHODOLOGY

# Operational Risk Assessment for European Structured Finance Originators

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## Related Research

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For a list of the Structured Finance related methodologies for our principal Structured Finance asset class methodologies that may be used during the rating process, please see the DBRS Global Structured Finance Related Methodologies document on [www.dbrs.com](http://www.dbrs.com). Please note that not every related methodology listed under a principal Structured Finance asset class methodology may be used to rate or monitor an individual structured finance or debt obligation.

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## Scope and Limitations

This report describes DBRS Ratings Limited's (DBRS) approach to evaluating the quality of the parties that originate loans that are about to be securitised or have previously been securitised in a transaction rated by DBRS. It is important to note that the methods described herein may not be applicable in all asset classes. Further, this methodology is meant to provide guidance regarding the DBRS methods used in the sector and should not be interpreted with formulaic inflexibility, but understood in the context of the dynamic environment in which it is intended to be applied.

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## Operational Risk Assessment for European Structured Finance Originators

### Introduction

DBRS operational risk assessment procedures for originators of European structured finance products, including residential mortgage-backed securities (RMBS), asset-backed securities (ABS) and loans to small- and medium-sized enterprises (SME) as well as covered bonds, are designed to evaluate the quality of the parties that originate the loans, receivables and/or leases to be securitised.

For multi-originator transactions, the review is typically done on originators that encompass 25% or more of a pool; however, a review may be conducted on an originator that has less than 25% of a pool if it contains a product that is deemed to have a higher-risk profile or if the originator has had a history of poor performance.

While DBRS does not assign formal ratings to these processes, it does conduct operational risk reviews to determine if an originator is acceptable and incorporates the results of the review into the rating process.

DBRS typically begins the initial originator review process by sending a questionnaire to the company that outlines the topics to be covered during discussions with management (Appendices 1 to 6). A date is usually then scheduled to either conduct an on-site visit of the company or have a call. During the on-site review and/or call, DBRS normally meets with senior management to discuss the lending operations, tour the facilities and review system demonstrations, as appropriate. DBRS assesses the information gathered through the review process to determine if an originator is acceptable. In instances where DBRS determines that the originator is below average, issuers may incorporate certain structural enhancements into a proposed transaction, such as additional credit support or enhanced representations and warranties, in order for DBRS to be able to rate the transaction.

In the event that DBRS determines that an originator's lending policy and procedures are particularly weak and the operational risks associated with poor origination practices are not sufficiently mitigated, DBRS may refuse to rate the deal.

### Originator Review Process

The originator review process typically involves a review and analysis of the following:

1. Company and management.
2. Financial condition.
3. Controls and compliance.
4. Origination and sourcing.
5. Underwriting guidelines.
6. Technology.

### Company and Management

DBRS believes that no origination operation can be successful without a strong, seasoned management team with expertise in the product(s) it is originating. As a result, DBRS views favourably management teams that possess ten or more years of experience. Additionally, DBRS believes that the participation of the credit-risk management, quality-control, legal and compliance departments in the origination and underwriting process is important in order to identify and mitigate risk. Furthermore, adequate capacity to handle fluctuations in loan/lease volume is also important. Furthermore, originators with experienced staff, manageable turnover rates and robust training programmes, including dedicated training resources and tools for monitoring staff participation are also viewed favourably by DBRS.

## Financial Condition

DBRS typically reviews an originator's financial condition or considers compensating factors. In its analysis, DBRS generally classifies an originator as investment grade or non-investment grade. Review of the originator may include an internal assessment consistent with DBRS policies (see DBRS's Internal Assessments Global Policy on [www.dbrs.com](http://www.dbrs.com)). To the extent that no public or private rating is maintained on the originator and no internal assessment is performed, DBRS generally assumes that the originator is non-investment grade.

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

- Company ownership structure.
- Business lines.
- Management experience.
- Corporate rating of any parent company (if applicable).
- Industry competitive landscape and company position.
- Internal and external audit results.
- Financial statements.
- Revenue sources 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 transfers.
- Securitisation history and future plans.

## Controls and Compliance

DBRS believes quality control reviews and internal assessments are important for a company's management to aid 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, as well as benchmarking those results to performance.

DBRS also believes that it is important for originators to be in compliance with the regulatory framework within their jurisdiction and be in good standing with their regulators. DBRS views favourably those originators that are not the subject of any regulatory investigation(s) and have few borrower complaints filed. DBRS also views favourably originators with minimal repurchases caused by breaches of representations and warranties or other breaches of eligibility and with robust procedures for vendor selection and oversight. Additionally, strong controls for managing potential conflicts of interest associated with parties to a transaction are also important.

## Origination and Sourcing

DBRS reviews the origination and sourcing channels to determine whether the originator has a clearly defined strategy. Approval and monitoring processes for third-party originators covering brokers, intermediaries and agents are also typically reviewed to determine the screening process. Furthermore, procedures that ensure new account set-up accuracy and data integrity are important to minimise errors. As a result, DBRS views favourably those originators with a high level of automation and established procedures for compliance with regulatory guidelines and industry best practices.

## Underwriting Guidelines

An originator's appetite for risk and the underlying quality of its underwriting guidelines can have an impact on deal performance; therefore, DBRS typically uses both a qualitative and quantitative approach to conduct its originator reviews and make comparisons among originators.

DBRS views those originators that have established guidelines and use reliable means to accurately assess a borrower's income and employment favourably. An originator's exception and override practices can help to assess the quality of the originations,

in addition to historical performance and repurchase volume. Furthermore, sophisticated technology and fraud detection procedures can help prevent early payment defaults. DBRS believes this area is important to maintaining a successful programme and, therefore, typically expects issuers to have formal processes surrounding fraud that are communicated regularly to staff and to employ experts to continuously update prevention strategies.

### **Residual Value Risk**

Residual value risk occurs where a contractual future cash flow relies on the disposal of an asset at the end of its lease or loan period (where the obligor has the right or option to return the vehicle to the financing company at maturity). As a general rule and as a result of depreciation, the longer the useful life or lease/loan period of an asset, the lower its residual value.

Contractual residual values are typically set according to published industry guidelines detailing predicted future values or as determined by proprietary models used by the originators utilising historical performance and insight into future market performance.

As part of a wider sales and marketing strategy, residual values at some companies may be subsidised by the manufacturer of the asset and be set at a higher level resulting in more affordable monthly payment amounts. A reduced monthly payment is achieved through the reduction in the amortising element of the lease or loan offset by an increased future residual value. This approach increases the risk at contract maturity that the sale or realisation of the asset may not cover the required contractual payment.

DBRS views favourably those originators that have sound residual value risk processes and governance in place and a proven track record of accurately predicting and setting residual values.

### **Valuation Practices**

Accurate appraisals of collateral, particularly real estate, for secured loans can greatly reduce losses to the receivable pool. As a result, DBRS favourably views a comprehensive asset evaluation process by the originator, with licensed appraisers who have no interest in the asset and receive no benefit from or compensation for the loan or lease approval. Where the appraisal is outsourced, DBRS typically expects a comprehensive approval and monitoring process of appraisers and their performance.

### **Technology**

Technology resources are an integral component of the originator review process. While DBRS does not subscribe to specific systems architecture, in reviewing the originator DBRS considers whether adequate systems controls, consumer privacy protection and back-up procedures, including disaster recovery and business continuity plans, are in place. Furthermore, originators are expected to monitor any offshore vendors and have a back-up plan in place to ensure minimal downtime. Over the past few years, leveraging the Internet has enabled many firms to operate effectively in the consumer lending business. Originators have used the Internet for marketing, customer service and the dissemination of pertinent information, such as applications and approvals. As a result, DBRS expects originators to have the appropriate staff and controls in place to provide website availability, account maintenance and enhancements. Sophisticated technology with robust functionality is viewed favourably by DBRS, as it often brings efficiency and predictability (in terms of asset performance) to the origination operations.

## Appendix 1: Sample Operational Risk Agenda for European RMBS and Covered Bond Originators

### ***Company and Management***

- Company history, ownership and operating experience.
- Financial condition/profitability.
- Ability to provide representations and warranties.
- Portfolio size and composition.
- Strategic initiatives.
- Recent or planned mergers or acquisitions.
- Risk management practices.
- Management experience.
- Number of employees and underwriters.
- Staffing, training and retention rates.
- Organisational charts.
- Use of outsourcing, temporary staff and offshore resources.
- Securitisation history and future plans.
- Historical performance of similar products.

### ***Controls and Compliance***

- Quality control (QC) and internal audit (IA) procedures.
- Internal and external audit results.
- Efforts to ensure regulatory compliance.
- Details of any current or past investigations or reviews carried out by regulators that have or may result in a monetary fine or penalty.
- Process for interpreting and tracking regulatory compliance statutes, including the use of counsel and compliance software.
- Repurchases due to breaches of representations and warranties (value and number).
- Corporate litigation (past, present and expected).
- Controls for managing potential conflicts of interest associated with parties to a transaction.
- Procedures for vendor selection and oversight.
- Storage and updating of policies and procedures.

### ***Origination and Sourcing***

- Origination strategy and channels.
- Sales and marketing practices.
- Use of brokers, intermediaries and other external channels.
- Approval and monitoring processes for third-party originators, brokers and intermediaries.
- Delegated underwriting practices and policies.
- Procedures for ensuring new loan set-up accuracy and data integrity.
- Exception and trailing documentation management.
- Post-closing quality reviews.

***Underwriting Guidelines***

- Underwriting policies and procedures by product and loan type.
- Details on whether underwriting is centralised or not.
- Recent or planned changes to underwriting guidelines.
- Approach to verifying income, assets, employment and occupancy documentation.
- Loan-to-value parameters.
- Qualifying rate and ratios and compliance with national usury laws.
- Documentation requirements, including Know Your Customer (KYC) checks.
- Occupancy and property eligibility.
- Insurance requirements.
- Foreign national requirements/eligibility.
- Procedures for ensuring compliance with regulatory lending laws.
- Use of credit scoring, automated underwriting and other technology and credit bureau(s) used.
- Underwriter compensation structure.
- Experience of underwriters, senior underwriters and team leaders.
- Authority levels.
- Exception and override process/practices.
- Process for completing data integrity checks.
- Fraud detection procedures and systems.
- Closing and funding process and interaction with originator(s).
- Trailing documentation follow-up.

***Valuations Practices***

- Methods and timelines used to assess property values.
- Procedures for validating values from appraisers, brokers and automated valuation models (AVMs).
- Outsourcing practices, including selection and oversight of valuation firms.
- Seasoned loan property evaluation practices.

***Technology***

- Core origination system strengths and weaknesses.
- Capacity remaining in the origination system.
- Website availability, usage and security.
- Procedures for vendor selection and oversight.
- Security measures employed to ensure compliance with national and EU data protection laws.
- Disaster recovery/business continuity plans and success of last test.
- Frequency of full-system backup.
- Future initiatives.

## Appendix 2: Sample Operational Risk Agenda for European SME Collateralised Loan Obligation Originators

### ***Company and Management***

- Company history, ownership and operating experience.
- Financial condition/profitability.
- Ability to provide representations and warranties.
- Portfolio size and composition.
- Recent or planned mergers or acquisitions.
- Market position and relationship to chief competitors, including company's competitive advantages/disadvantages.
- Management experience.
- Staff experience, training and retention rates.
- Employee remuneration, performance and monitoring procedures.
- Use of outsourcing, temporary staff and offshore resources.
- Organisational charts.
- Securitisation history and future plans.
- Historical performance of similar products.

### ***Controls and Compliance***

- Overview of compliance controls (legal, regulatory, etc.).
- Internal and external audit results.
- Details of any current or past investigations or reviews carried out by regulators that have or may result in a monetary fine or penalty.
- Corporate litigation (past, present and expected).
- Storage and updating of policies and procedures.

### ***Origination and Sourcing***

- Origination strategy and channels.
- Sales and marketing practices.
- Use of brokers, intermediaries and other external channels.
- Approval and monitoring processes for third-party originators, brokers and intermediaries.
- Documentation requirements, including borrower checks.
- Originator, sales agents and underwriters compensation structure.

### ***Underwriting Guidelines***

- Underwriting policies and procedures by product and loan type.
- Details on whether underwriting is centralised or not.
- Use of credit scoring, automated underwriting and other technology and credit bureau(s) used.
- Design of risk-scoring model, including quantitative and qualitative elements, use of external developers and evolution of model(s).
- Process for validating and back-testing credit/risk-scoring model(s).
- Approach to verifying income, assets and employment.
- Experience of underwriters and credit risk analysts.
- Recent or planned changes to underwriting and/or credit policy guidelines.
- Exception and override process/practices and approval requirements.
- Fraud detection procedures and systems.

***Valuations Practices***

- Appraisal process and use of internal and external valuation models and firms.
- Outsourcing practices, including selection, approval and oversight of external appraisers.
- Procedures for validating values from external sources, including AVMs.

***Technology***

- Core origination system strengths and weaknesses.
- Capacity remaining in the origination system.
- Website availability, usage and security.
- Procedures for vendor selection and oversight.
- Security measures employed to ensure compliance with national and EU data protection laws.
- Disaster recovery/business continuity plans and success of last test.
- Frequency of full-system backup.
- Future initiatives.

## Appendix 3: Sample Operational Risk Agenda for European ABS Consumer/Unsecured Loan Originators

### ***Company and Management***

- Company history, ownership and operating experience.
- Financial condition/profitability.
- Ability to provide representations and warranties.
- Portfolio size and composition.
- Strategic initiatives, overview of industry, leading competitors and trends.
- Recent or planned mergers or acquisitions.
- Risk management practices.
- Management experience.
- Number of employees and underwriters.
- Staffing, training and retention rates.
- Organisational charts.
- Securitisation history and future plans.
- Historical performance of similar products.

### ***Controls and Compliance***

- QC and IA procedures.
- Internal and external audit results.
- Efforts to ensure regulatory compliance.
- Details of any current or past investigations or reviews carried out by regulators that have or may result in a monetary fine or penalty.
- Process for interpreting and tracking regulatory compliance statutes, including the use of counsel and compliance software.
- Repurchases due to breaches of representations and warranties (value and number).
- Corporate litigation (past, present and expected).
- Controls for managing potential conflicts of interest associated with parties to a transaction.
- Procedures for vendor selection and oversight.
- Storage and updating of policies and procedures.

### ***Origination and Sourcing***

- Origination strategy and channels.
- Sales and marketing practices, including any pre-approval campaigns.
- Use of brokers, intermediaries and other external channels, such as the Internet.
- Approval and monitoring processes for third-party originators, brokers and intermediaries.
- Delegated underwriting practices and policies.
- Details on how the bank competes for new business (e.g., incentives, reduced documentation requirements).
- Details on target markets and primary competitors.
- Procedures for ensuring new loan setup accuracy and data integrity.
- Post-origination quality reviews.

***Underwriting Guidelines***

- Underwriting policies and procedures by product and loan type.
- Details on whether underwriting is centralised or not.
- Recent or planned changes to underwriting guidelines.
- Underwriting process for pre-approved customers.
- Documentation requirements, including KYC checks.
- Process for co-signers and/or guarantees.
- Foreign national requirements/eligibility.
- Insurance requirements, if applicable.
- Procedures for ensuring compliance with regulatory lending laws.
- Use of credit scoring, automated underwriting and other technology and credit bureau(s) used.
- Process and frequency for validating and/back testing models.
- Underwriter compensation structure.
- Experience of underwriters, senior underwriters and team leaders.
- Authority levels.
- Exception and override process/practices.
- Payment terms by product.
- Process for completing data integrity checks.
- Fraud detection procedures and systems.

***Technology***

- Core origination system strengths and weaknesses.
- Capacity remaining in the origination system.
- Website availability, usage and security.
- Procedures for vendor selection and oversight.
- Security measures employed to ensure compliance with national and EU data protection laws.
- Disaster recovery/business continuity plans and success of last test.
- Frequency of full-system backup.
- Future initiatives.

## Appendix 4: Sample Operational Risk Agenda for European ABS Auto Loan and Lease Originators

### ***Company and Management***

- Company history, ownership and operating experience.
- Financial condition/profitability.
- Ability to provide representations and warranties.
- Portfolio size and composition.
- Strategic initiatives, overview of industry, leading competitors and trends.
- Recent or planned mergers or acquisitions.
- Risk management practices.
- Management experience.
- Number of employees and credit officers/underwriters.
- Staffing, training and retention rates.
- Organisational charts.
- Use of outsourcing, temporary staff and offshore resources.
- Securitisation history and future plans.
- Historical performance of similar products.

### ***Controls and Compliance***

- QC and IA procedures.
- Internal and external audit results.
- Efforts to ensure regulatory compliance.
- Details of any current or past investigations or reviews carried out by regulators that have or may result in a monetary fine or penalty.
- Process for interpreting and tracking regulatory compliance statutes, including the use of counsel and compliance software.
- Repurchases due to breaches of representations and warranties (value and number).
- Corporate litigation (past, present and expected).
- Controls for managing potential conflicts of interest associated with parties to a transaction.
- Procedures for vendor selection and oversight.
- Storage and updating of policies and procedures.

### ***Origination and Sourcing***

- Origination strategy and channels.
- Sales and marketing practices.
- Use of dealers, brokers, intermediaries and other external channels.
- Approval and monitoring processes for dealers, brokers and intermediaries.

### ***Underwriting Guidelines***

- Underwriting policies and procedures by product and loan type.
- Recent or planned changes to underwriting guidelines.
- Approach to verifying income and employment documentation.
- Documentation requirements, including KYC checks.
- Procedures for ensuring compliance with regulatory lending laws.

- Use of credit scoring, automated underwriting and other technology and credit bureau(s) used.
- Underwriter compensation structure.
- Experience of underwriters, senior underwriters and team leaders.

**Authority levels**

- Exception and override process/practices.
- Fraud detection procedures and systems.
- Closing and funding process.

**Residual Value**

- Process for setting residual values (RV) including thresholds for RV risk.
- RV approval process and committee format/quorum, if applicable.
- External benchmarking of RVs.
- Are any proprietary models used?

**Technology**

- Core origination system strengths and weaknesses.
- Capacity remaining in the origination system.
- Website availability, usage and security.
- Procedures for vendor selection and oversight.
- Security measures employed to ensure compliance with national and EU data protection laws.
- Disaster recovery/business continuity plans and success of last test.
- Frequency of full-system backup.
- Future initiatives.

## Appendix 5: Sample Operational Risk Agenda for European ABS Commercial Lease Originators

### ***Company and Management***

- Company history, ownership and operating experience.
- Financial condition/profitability.
- Ability to provide representations and warranties.
- Portfolio size and composition.
- Strategic initiatives, overview of industry, leading competitors and trends.
- Recent or planned mergers or acquisitions.
- Management experience.
- Number of employees and underwriters.
- Staffing, training and retention rates.
- Organisational charts.
- Securitisation history and future plans.
- Historical performance of similar products.

### ***Controls and Compliance***

- QC and IA procedures.
- Internal and external audit results.
- Efforts to ensure regulatory compliance.
- Details of any current or past investigations or reviews carried out by regulators that have or may result in a monetary fine or penalty.
- Process for interpreting and tracking regulatory compliance statutes, including the use of counsel and compliance software.
- Repurchases due to breaches of representations and warranties (value and number).
- Corporate litigation (past, present and expected).
- Controls for managing potential conflicts of interest associated with parties to a transaction.
- Procedures for vendor selection and oversight.
- Storage and updating of policies and procedures.

### ***Origination and Sourcing***

- Origination strategy and channels.
- Sales and marketing practices.
- Use of dealers, brokers, intermediaries and other external channels.
- Approval and monitoring processes for dealers, third-party originators, brokers and intermediaries.
- Delegated underwriting practices and policies.
- Procedures for ensuring new loan set-up accuracy and data integrity.
- Exception and trail documentation management.
- Post-closing quality reviews.

***Underwriting Guidelines***

- Underwriting policies and procedures by product and lease type.
- Details on whether underwriting is centralised or not.
- Recent or planned changes to underwriting guidelines.
- Approval process for potential lessees.
- Documentation requirements, including KYC checks.
- Foreign national requirements/eligibility.
- Procedures for ensuring compliance with regulatory lending laws.
- Use of credit scoring, automated underwriting and other technology and credit bureau(s) used.
- Underwriter compensation structure.
- Experience of underwriters, senior underwriters and team leaders.
- Authority levels.
- Exception and override process/practices.
- Process for completing data integrity checks.
- Fraud detection procedures and systems.
- Closing and funding process and interaction with originator(s).

***Technology***

- Core origination system strengths and weaknesses.
- Capacity remaining in the origination system.
- Website availability, usage and security.
- Procedures for vendor selection and oversight.
- Security measures employed to ensure compliance with national and EU data protection laws.
- Disaster recovery/business continuity plans and success of last test.
- Frequency of full-system back-up.
- Future initiatives.

## Appendix 6: Sample Operational Risk Agenda for European ABS Credit Card Originators

### ***Company and Management***

- Company history, ownership and operating experience.
- Financial condition/profitability.
- Ability to provide representations and warranties.
- Portfolio size and composition.
- Strategic initiatives, overview of industry, leading competitors and trends.
- Recent or planned mergers or acquisitions.
- Management experience.
- Number of employees and underwriters.
- Staffing, training and retention rates.
- Organisational charts.
- Securitisation history and future plans.
- Historical performance of similar products.

### ***Controls and Compliance***

- QC and IA procedures.
- Internal and external audit results.
- Efforts to ensure regulatory compliance.
- Details of any current or past investigations or reviews carried out by regulators that have or may result in a monetary fine or penalty.
- Process for interpreting and tracking regulatory compliance statutes, including the use of counsel and compliance software.
- Repurchases due to breaches of representations and warranties (value and number).
- Corporate litigation (past, present and expected).
- Controls for managing potential conflicts of interest associated with parties to a transaction.
- Procedures for vendor selection and oversight.
- Storage and updating of policies and procedures.

### ***Origination and Sourcing***

- Origination strategy and channels.
- Sales and marketing practices, including any pre-approval campaigns.
- Use of brokers, intermediaries and other external channels, such as the Internet.
- Approval and monitoring processes for third-party originators, brokers and intermediaries.
- Delegated underwriting practices and policies.
- Details on how the bank competes for new business (e.g., incentives, reduced documentation requirements).
- Details on target markets and primary competitors.
- Process for ensuring credit card set-up accuracy and completing data integrity checks.
- Post-origination quality reviews.

***Underwriting Guidelines***

- Underwriting policies and procedures by product and loan type.
- Details on whether underwriting is centralised or not.
- Recent or planned changes to underwriting guidelines.
- Approach to verifying income and employment.
- Documentation requirements, including KYC checks.
- Underwriting process for pre-approved customers.
- Details on repayment terms.
- Process for co-signers and/or guarantees.
- Exception and override process/practices.
- Use of credit scoring, automated underwriting and other technology and credit bureau(s) used.
- Underwriter compensation structure, including incentives and bonuses.
- Experience of underwriters, senior underwriters and team leaders.
- Procedures for ensuring compliance with regulatory lending laws.
- Funding process/delivery of cards.

***Technology***

- Core origination system strengths and weaknesses.
- Capacity remaining in the origination system.
- Website availability, usage and security.
- Procedures for vendor selection and oversight.
- Security measures employed to ensure compliance with national and EU data protection laws.
- Disaster recovery/business continuity plans and success of last test.
- Frequency of full-system back-up.
- Future initiatives.



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