P.R.I.M.E. Finance New York Conference 2025

Operational Risks and Fraud in Securitization

FTI CONSULTING

October 30, 2025

Current Situation:

- Controls that work exist.
- Implementation may be lacking.

Let’s Discuss:

- Is it possible to limit exposure before bankruptcy?
- What actually changes behavior?

Why This Matters:

- Two major bankruptcies in 30 days with more allegations emerging
- Same fraud mechanics as 1990s, 2008, 2020
  - *Why haven’t we fixed this?*
- Technology exists to mitigate this.
- Looking ahead, these risk factors can come into play:
  - Private credit’s expansion and level of transparency
  - Expanding asset classes with untested controls
  - AI facilitating fraud at document/borrower level

Recent High-Profile Bankruptcies

TRICOLOR HOLDINGS: *Subprime Auto Lender – Chapter 7*

A Double-Pledging Cascade

Allegations

- 29K loans (40% of active portfolio) double-pledged to multiple warehouse lenders
- Loan tapes showed repossessed vehicles as current
- When one lender demanded reconciliation, cross-defaults cascaded

FIRST BRANDS GROUP: *Auto Parts Supplier – Chapter 11*

Receivables Illusion

Allegations

- $10B+ total debt disclosed (vs. previous understanding of $6.1B on-balance-sheet)
- $2.3B in hidden off-balance-sheet factoring liabilities
- Suspected $2B in double-pledged receivables across facilities
- Invoices inflated to meet credit line covenants

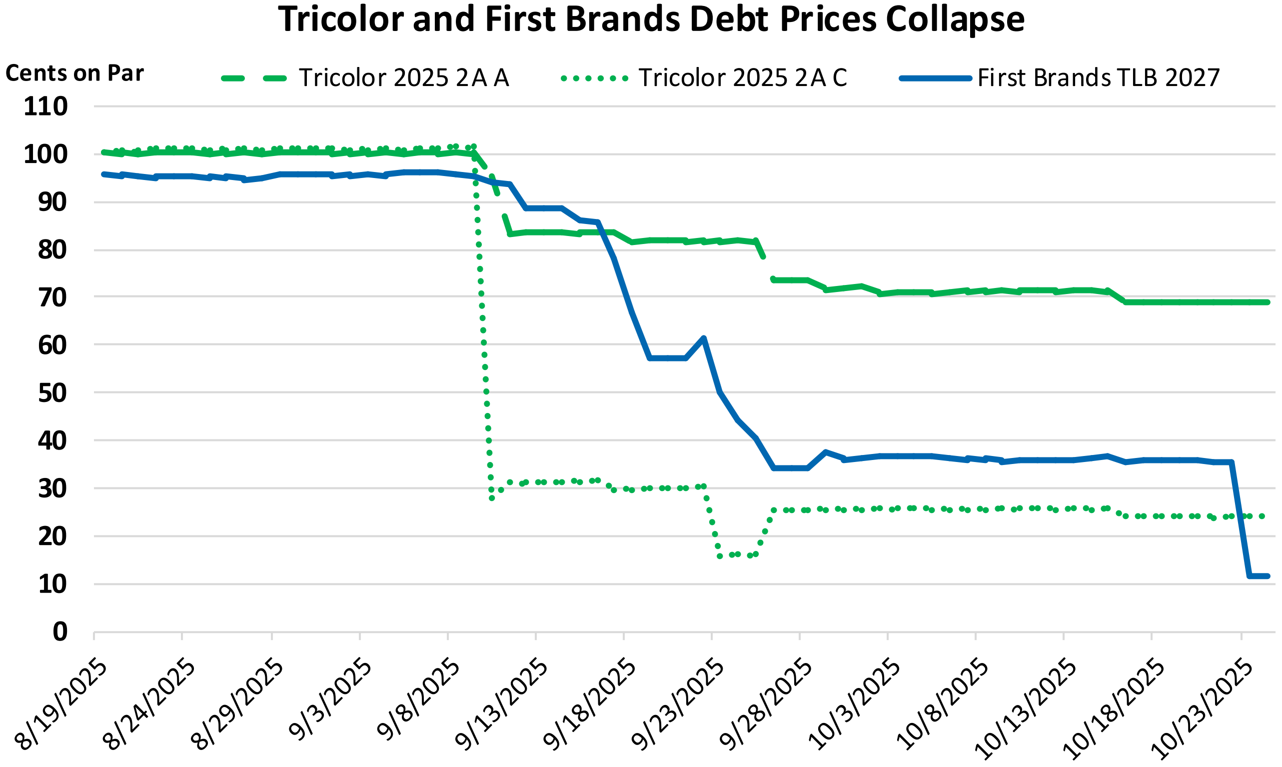
Why Controls Failed

Tricolor Holdings	First Brands Group
▪ No centralized VIN registry across warehouse facilities	▪ No verification of invoices against shipments/contracts
▪ Servicer (Tricolor itself) controlled e-chattel paper	▪ Multiple lenders accepted same receivables without anti-collision checks
▪ Each warehouse relied on borrowing base certificates w/o independent verification	▪ Audit sampling missed systematic discrepancies
▪ Backup servicer had no data access until post-default	▪ Sponsor controlled confirmation process

Pattern: Limited oversight + weak verification + uncoordinated lenders = vulnerability

**Note: Case descriptions based on public filings and reports; litigation ongoing*

These have shaken markets



Source: Capital IQ

Tricolor

- Five ABS deals issued in 2024 and 2025, where total issued balance = $1.4B
- Total size of the subprime auto ABS market: $80 B

First Brands Group

- Total estimated liabilities: $10B+ across CLOs, Private Credit, BDCs, bank-owned funds
- $2.3 billion to third-party

Same Playbook of Preventable Fraud

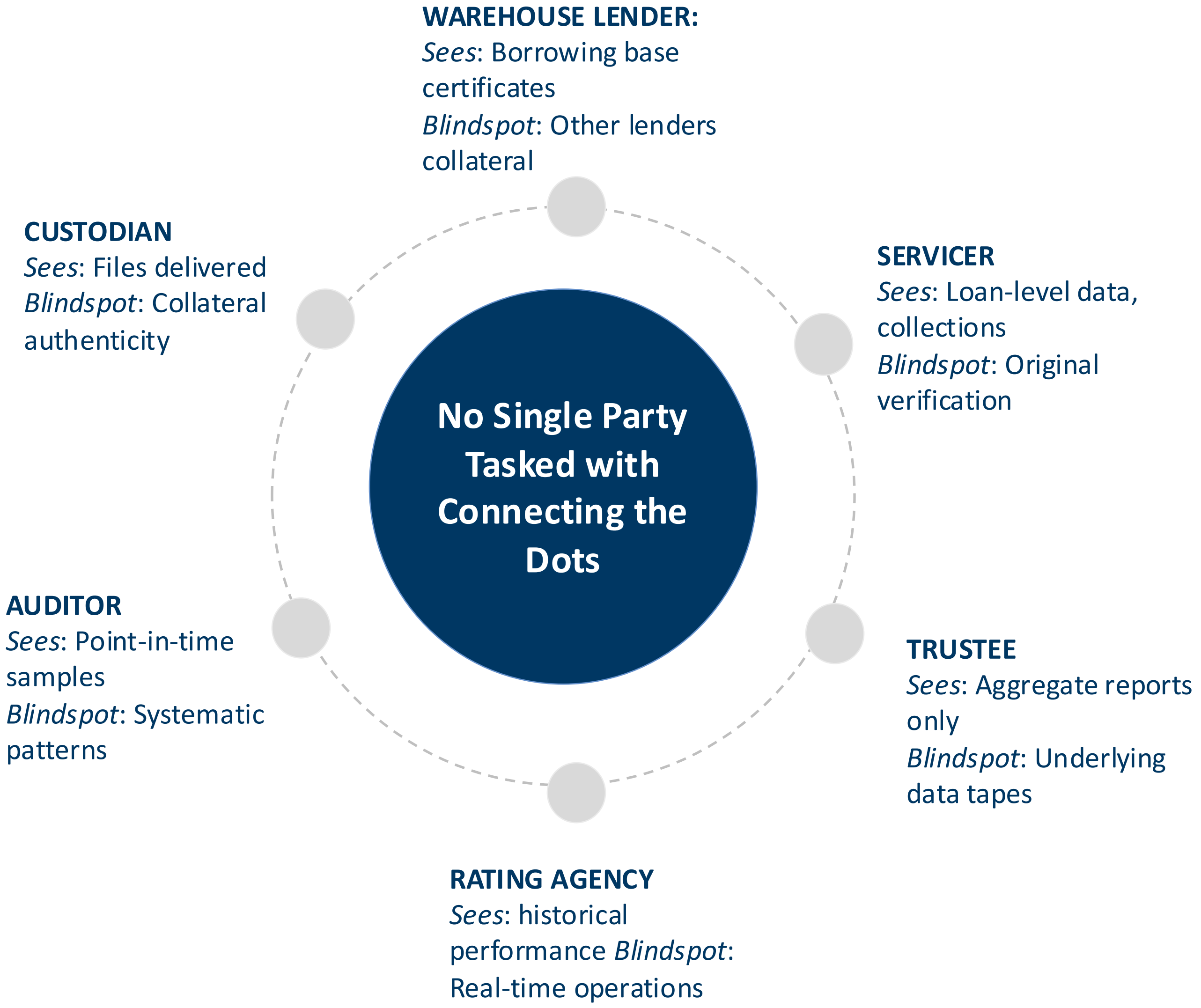
Historical Cases and What Could Have Prevented Them

Case	Fraud Accusations	What Could Have Stopped it
NCFE (National Century Financial Enterprises) **(2002)**	▪ Falsified $3B healthcare receivables ▪ Created fictitious accounts receivable to inflate assets ▪ Masked cash shortfalls via fraudulent inter-account transfers ▪ Diverted investor funds to insiders and failing providers	▪ Independent trustee with direct payer access ▪ Hard-wired reconciliation process
CMBS Issues **(2013-19)**	▪ Inflated net operating income ▪ Unjustified property valuation adjustments ▪ Sales pressure overrode controls ▪ Manipulated financial data	▪ Independent underwriting ▪ Mandatory separation of sales and risk functions
Greensill **(2021)**	▪ $10B+ supply chain finance collapse ▪ Financed "prospective" invoices ▪ Recycled same invoices across multiple deals ▪ Concentrated exposure disguised as diversified	▪ Strict eligible receivables definition ▪ Exclude prospective or contingent claims
777 Partners **(2023)**	▪ Pledged non-existent assets via falsified financials ▪ Double-pledged $146M in annuity collateral ▪ Borrowed against non-existent/overdrawn assets	▪ Centralized collateral registry ▪ Independent asset verification at closing
Solar ABS **(2015-2025)**	▪ Alleged premature funding on unfinished/phantom installs ▪ Continued billing/lien filings and collections despite cancellations ▪ Inflated receivable values without work verification	▪ Independent milestone checks before disbursements ▪ Third-party inspections and verification audits ▪ Suspension triggers for non-performance

Reoccurring Patterns

- **Data Capture Monopoly** – One entity controlled all reporting, data feeds, or collateral records
- **Fragmented Oversight** – Multiple lenders operated independently with no coordinated surveillance
- **Crisis Triggered Discovery** – Issues surfaced only when liquidity stress forced reconciliation
- **Inadequate Verification** – Overreliance on sampling or sponsor-supplied data missed systemic red flags
- **Opaque Structures** – Complexity of securitization layers hindered asset verification

The Coordination Failure: No One Sees the Whole Picture



Inherent Issues

Conflicting Interests

- Originators maximize volume
- Lenders compete on speed/terms
- Rating agencies compete for mandates

Information Asymmetry

- Sponsor controls source data
- Investors see lagged, aggregated reports
- Verification gaps across handoffs

Coordination Difficulty

- No single party has full picture
- Each optimizes local responsibilities

Complexity

- Multiple intermediaries, layered structures
- Information siloed across parties
- System-level risk falls through cracks

Incentive Alignment

- **Originators** → Maximize volume, minimize friction
- **Warehouse lenders** → Compete on speed and terms
- **Rating agencies** → Win mandates, scope to budget
- **Auditors** → Limit scope to control costs

Result

- Everyone optimizes local incentives
- Creating systematic vulnerability

Control Solutions Exist – Why Aren't They Standard?

Three Core Protections That Could Help Most

Centralized Collateral Registry

- Real-time database flags duplicate pledges across lenders
- **Precedent:** MERS tracks 65%+ of U.S. mortgages
- **Barrier:** No industry consortium; first-mover disadvantage

E-Chattel with Independent Custody

- Third-party vault holds single authoritative copy
- Attestation required at closing and monthly
- Technology exists; adoption <5%
- **Barrier:** Warehouse lenders don't require it

Independent Warehouse-to-Term Reconciliation

- Third-party verification that warehouse lien released
- before term lien attaches
- Custodian attestation as closing condition
- Minimal cost if built into process
- **Gap:** Currently relies on sponsor attestation

Implementation Challenge

Economic Factors:

- **Cost:** Controls add friction when fraud risk seems low
- **First-mover disadvantage**: Lender requiring verification loses deals to competitors
- **Network effects**: Registry only works with critical mass participation

Behavioral Problem:

- Optimism bias in benign credit environments
- Warehouse lenders optimize for speed, not security
- "Trust but verify" becomes just "trust" under competitive pressure

What Changes Behavior:

- Fraud losses exceed control costs
- Regulatory mandate
- Insurance requirements

Control Solutions Exist – Additional Controls

Operational Controls

Continuous Asset Verification

- Trace every receivable/loan to authoritative source:
- **For receivables:** Invoice → Purchase order → Delivery receipt → Customer confirmation
- **For secured loans:** Verify collateral existence, condition, lien perfection
- **Tools:** Invoice hashing, VIN registries, direct customer outreach
- **Adoption barrier:** Adds friction; sponsors resist

Real-Time Borrowing Base Monitoring

- Recompute by independent calculation agent
- Automated data feeds from servicer
- **Adoption:** Growing in stressed sectors, not standard in benign markets

Emerging Tech for Surveillance

Pattern Detection:

- Statistical and AI tools in analyzing reported data
- Anomaly detection in loan characteristics (e.g. oscillating statuses, missing fields)
- Real-time red flag monitoring across portfolio

Implementation Reality:

- High false-positive rates require judgment
- Works best as early warning system
- Being tested at some institutional investors

Drafting Protections that Survive Insolvency

The Problem with R&Ws (Representation & Warranties)

- Standard R&Ws fail when you need them
- Only structural protections and hard-wired covenants survive insolvency

When R&Ws Break:

- Breach discovered often after sponsor bankruptcy
- Repurchase obligation = unsecured claim against shell entity
- Indemnity from same bankrupt sponsor = worthless

The Solution Is Layered Defense

- R&Ws with Teeth: Independent verification as closing condition
- Enforcement Mechanisms: Triggers activate early, while sponsor still solvent
- Structural Backstops: Reserves, over collaterization
- Ongoing Monitoring: Hardwired as covenants
- Covenant triggers such as >2% issues = review; >5% = early amortization"
- Investor Directed Audits: (e.g. 25% of class can trigger)

Document Strategies:

1. Convert Representations into Structural Requirements

- Independent verification as closing condition (not just rep)
- Third-party custody appointment requirement
- Cross-facility database check as prerequisite

2. Create Third-Party Liability

- Servicer/custodian representations (*separate liability*)
- Independent party certifications *(direct claims)*
- Hot backup attestations with liability

3. Hard-Wire Ongoing Monitoring

- Monthly verification covenants
- Quarterly field examination mandates
- Automatic servicer replacement triggers
- Trustee investigation mandates

Key Takeaways – The Pattern is Clear

Fraud follows the same playbook across decades:

- Single-party data control + fragmented lenders + weak verification
- NCFE (2002) → Greensill (2021) → 777 Partners (2023) → Tricolor (2025)
- Same fraud mechanics decades apart

Early warning signs exist:

- Data anomalies, missing fields
- Pressure from covenant breaches or tight liquidity
- Unfulfilled repurchase demands

But detection happens often too late.
Only when liquidity crisis forces reconciliation.

In securitization, operational failures don't stay operational. They may metastasize into fraud claims.

How We Can Fix This:

Technology and controls exist to reduce fraud:

- Registries and cross-lender databases (prevent double-pledging)
- Independent verification at closing (detect fake collateral)
- Real-time monitoring with automated alerts (catch anomalies early)
- Hot backup servicers with continuous oversight

Design Guidelines:

- **Assume sponsor insolvency** – Structural protections survive bankruptcy
- **Demand independent verification** – Controls as closing conditions
- **Hard-wire ongoing monitoring** – Covenants that activate automatically

DRAFT – Subject to Change
Privileged and Confidential

Key Players and Their Blind Spots

Party	Supposed to Do	Failure
Underwriters / Arrangers	Conduct due diligence, ensure disclosure is accurate, structure the deal responsibly	Rely heavily on reps and warranties, limited re-underwriting, pressure to place deals quickly
Warehouse Lenders	Verify borrowing base certificates, enforce collateral eligibility	Over-reliance on borrower reports, limited real-time collateral ID checks, slow to detect double-pledging.
Servicer	Maintain authoritative records; flag anomalies; generate accurate loan tapes	Maintain ambiguous collateral status enabling re-use; generate certificates without verification
Custodian	Maintain physical/electronic possession of collateral and loan files; verify completeness	Fail to cross-check duplicate pledging across facilities; accept servicer representations without verification
Trustee	Pre-default: Ministerial duties Post-EOD: Prudent person standard (TIA §315)	Gray zone data anomalies that aren't yet EOD linger if they aren't formally defined as EOD events; Percentage of pool in "unknown" status
Rating Agencies	Assess operational risk; monitor and downgrade when controls deteriorate	Treating operational risk as binary ("adequate" or NR); surveillance focuses on performance, not data integrity
Auditors	Ensure that asset quality is upheld; establish the legitimacy of the asset documentation	Overreliance on sampling or sponsor-supplied data
Backup servicer	Step in if the primary servicer defaults, ensuring continuity	Often only *cold* backups with no live data feeds; can be too little, too late when fraud or collapse occurs.
Investors	Conduct independent analysis, stress-test collateral assumptions	Rely on rating agencies, auditors, offering documents, or trustee reports without independent collateral checks

The Coordination Problem

No single party tasked with connecting the dots

- Warehouse lenders do not independently verify borrowing base certificates.
- Servicer sees loan-level data.
- Trustee sees aggregate reports.
- Rating agency sees historical performance.
- Auditor samples at point-in-time.
- Custodian holds files without cross-checking.
- No one cross-checks for systematic collateral reuse or fabrication.

Watch for Early Red Flags

Data Integrity

- Many loans in an unknown status
- Loans oscillating between current and delinquent without payments
- Loans missing key fields, such as VIN, borrower name, and dates
- Benford's Law violations in reports
- Late or incomplete investor reports
- Frequent corrections/restatements

Operational

- Commingling of trust funds
- Unfulfilled repurchase demands
- Lack of separation of roles duties: when same entity assumes multiple roles as in originator, servicer, trustee, or custodian
- Weak internal controls and uncoordinated lenders
- Rationalization, e.g., just temporary, from the originator/borrower
- Pressure from proximity covenant breach or tight liquidity environment

Let’s Discuss

1. **Patterns of fraud**
   What stops the same type of fraud recurring?

2. **Single most effective control**
   If you could mandate one change market-wide, what would it be?

3. **Implementation barriers**
   Why do obvious solutions remain overlooked: cost, coordination, or incentives?

4. **2025 inflection point**
   Three frauds in 4 year. Is this the moment behavior changes?

5. **New asset classes and new technologies**
   Are we repeating past mistakes or learning?

Let’s Stay Connected!

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