Wolters Kluwer's Expert Insights

Creating Digital Asset Certainty: Credit Risk Management for Digital Lending

An executive discussion on Digital Asset Certainty and Credit Risk Management considerations with Steve Bisbee, Senior Advisor for Applied Technology, Wolters Kluwer Compliance Solutions

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Compliant, transferable financial assets are the cornerstone of financial markets liquidity

Acceptance of the securitization of digital assets by rating agencies and regulators began over a decade ago. Though compliant, transferable financial assets are the cornerstone of financial markets liquidity, we do not yet have established criteria at the legislative and regulatory levels for Digital Asset Certainty.
Read further for guidance on why Digital Asset Certainty measures are needed to ensure that digital financial assets meet risk management requirements.

Steve Bisbee, Senior Advisor for Applied Technology at Wolters Kluwer Compliance Solutions, provides his expert perspectives on digital lending. Steve is the founder of eOriginal, Inc., a leading solutions platform for creating, managing, and monetizing trusted digital loans. Wrapping digital business and legal processes in security technologies, eOriginal minimizes the inefficiencies of paper-based transactions and was used to enable the first fully digital mortgage, automotive, equipment lease, and international trade transactions.
In 2020, eOriginal was acquired by Wolters Kluwer to better support digital financial solutions worldwide.

Broadly speaking, Digital Asset Certainty minimizes unnecessary risk for financial services organizations and the digital finance industry in general. It does so by safeguarding digital financial assets as the cornerstone of liquidity in financial markets.

Q: What are the major market drivers for Digital Asset Certainty, and why should these measures be put in place?

Steve: First some context: for eOriginal and Wolters Kluwer, digital assets are those finance agreements – usually consumer loans – that require payment obligations by the borrower to the lender. There are specific legal and regulatory requirements to ensure their enforceability and the ability to sell or transfer these assets to an unrelated third party while still carrying with it the holder-in-due-course rights to the associated payment streams.

A successful digital lending solution must be purpose-built to create and maintain these rights with a "first priority"' security interest or lien in any collateral pledged to support the borrower's payment obligations. This first priority lien must be maintained throughout the loan's lifecycle – including creating and closing the loan, managing it, and monetizing it by selling or offering to investors in the secondary market.

Asset certainty, of course, is critical whether the loan is digital or paper. In both cases, the asset represents the obligation to pay. There must be absolute certainty from the perspectives of judicial admissibility, legal enforceability, and regulatory compliance. The question for digital loans is how to best do it.

We've developed the concept of a Digital Original® – an asset that is unique, immutable, verifiable, authenticated, distinguishable from all other copies, and properly identifies the party entitled to the payments. Legislative and regulatory efforts have already focused on the enablement of digital finance, credit, and data standards. Now we need to encourage Digital Asset Certainty criteria within the practice of Credit Risk Management.

This is particularly critical as digital lending seeks to scale beyond the early adopter stage. With COVID-19, we saw a "Big Bang" level of adoption for remote and contactless digital transaction engagement. As consumers continue to prefer, or require, such engagement – and as financial regulatory agencies such as the Consumer Financial Protection Bureau (CFPB) expand their oversight – the need for such a Digital Original has become critical.

Q: What are some of the key benefits of Digital Asset Certainty and specifically the creation of Digital Asset Certainty standards within Credit Risk Management criteria?

Steve: Broadly speaking, Digital Asset Certainty minimizes unnecessary risk for financial services organizations and the digital finance industry in general. It does so by safeguarding digital financial assets as the cornerstone of liquidity in financial markets.

For loan originators and investors, attention is often focused on creditworthiness, agreement terms and conditions, and loan payment performance. However, the financial asset – whether paper or digital – is the foundation for the obligations of all involved parties. If the financial asset is not available, verifiable, or compliant, the value of the transaction evaporates.

So, creating and maintaining Digital Asset Certainty is important across a range of areas in the financial services market. It underpins the liquidity of financial markets themselves and increases confidence by providing a clear set of criteria for what constitutes a legitimate asset. Loans are then securitized according to SEC regulations with all proper rating agency support. Lenders and investors can act with confidence that a market actually exists – which means they know assets can be sold or transferred as needed. This is the benefit of Digital Asset Certainty.

Q: What are some key considerations for Digital Asset Certainty and Credit Risk Management from a classic "people, business, and technology" perspective?

Steve: From a people perspective, Digital Asset Certainty supports the enforceability of agreements in court where digital assets are admissible on par with paper assets. And where digital assets are created and managed in full alignment with regulatory bodies, they can be quickly identified, verified, audited or bundled and sold if needed. This can be a great benefit in a lending crisis like the one we saw in 2008.

On the business side, there are key statutes in place that enable digital lenders to operate with critical guardrails. Some of these include revisions to the Uniform Commercial Code (UCC), article 9 of the Uniform Electronic Transactions Act (UETA), ESIGN, and others. In addition, we have fair lending requirements for extending credit to the unbanked and underserved and a growing list of standards-enforcing organizations guiding the industry – including MISMO (Mortgage Industry Standards Maintenance Organization) for mortgages and ELFA (Equipment Leasing and Finance Association).

From a technology perspective, it is difficult to create Digital Asset Certainty without a public key infrastructure (PKI) to track transaction data and enable a transparent digital ledger as available in blockchain and other PKI based applications such as Wolters Kluwer's eOriginal solutions. You should utilize cryptographic hashing to create tamper-proof seals and digital signature authentication to support Digital Asset Certainty.

Top 10 Credit Risk Management considerations to ensure compliance and success

We asked Steve for a list of key Credit Risk Management considerations. Here are his thoughts:

1. **Consumer protection and investor confidence**
   Creating transparency and building a sustainable market requires assets that everyone can trust

2. **Enforceability of transferable records or negotiable instruments**
   When disputes arise, digital assets need to stand on par or better with paper for admissibility and enforceability court

3. **Regulatory alignment**
   Digital assets that don't comply with regulations by design are untenable at best

4. **Participant responsibility**
   Clears rules of the road need to be built into the lifecycle of each digital asset

5. **Financial markets liquidity**
   Digital Asset Certainty is the foundation of liquidity. Without certainty, there is no market

6. **Lending crisis safeguard**
   Digital assets with certainty can be quickly verified and audited during a crisis and monetized to avoid or reduce losses

7. **Securitization protections**
   Digital Asset Certainty minimizes fraud by ensuring the legitimacy of assets behind the securities

8. **Digital asset security**
   Compliant digital assets are more secure than paper and easier to monitor at scale

9. **Lender capital protection**
   Digital Asset Certainty creates a trusted secondary market for digital loans for lenders to quickly recycle their capital

10. **Technology-enabled trusted assets and transactions**
    The right, purpose-built, technology platform is needed for sustainable and scalable Digital Asset Certainty throughout the life cycle of the assets

For more information on Digital Asset Certainty and Digital Original®, please visit Wolters Kluwer's eOriginal® Compliance Solutions to simplify digital lending from the close to the secondary market.

***Steve Bisbee** is Senior Advisor, Applied Technologies for Wolters Kluwer. Steve is the founder of eOriginal, Inc. a leading digital lending platform acquired by Wolters Kluwer in 2020. A pioneer in both the technology and regulatory considerations in digital lending, he is widely regarded as one of the most authoritative voices in the field.*

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