Due Diligence DIY

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Due diligence terminology in the securities markets can be traced back a long way. The U.S. Securities Act of 1933 imposed penalties and direct liability on sellers of instruments sold with offering materials if there were any omissions hindering an investor's understanding of the security. Qualified third parties entered the fold and were used by sellers to perform certain aspects of due diligence. Common practices evolved globally under a legal notion of due diligence, but post-crisis the securitization market abides by a more complete and practical interpretation of the term.

In January 2011, Article 122a of the revised E.U. Capital Requirements Directive went live, imposing direct responsibilities on investors to perform adequate due diligence and issuers to provide appropriate levels of transparency. It is more than just a minimum audit requirement. Due diligence now includes comprehensive credit analysis, risk management from the collateral level up and an array of specific activities related to the initial and ongoing understanding of the risk dynamics of structured finance assets and portfolios.

The overriding message in the implementation of new guiding principles is that credit institutions cannot rely on third parties when gaining an understanding of transactions. Investors must perform the analysis required to verify valuations, performance assumptions and future cashflows and be able to act on their own assessments. Only then can they satisfy Europe's national supervisors.

The **Committee of European Banking Supervisors**, now the **European Banking Authority**, were charged by the **Financial Stability Board** with presenting a coordinated response to help guide the consistent implementation of Article 122a across E.U. jurisdictions.

Any institution that assumes exposure to the creditworthiness and principal loss of a securitization, whether through direct investment, liquidity support or as a hedge counterparty, will be required to prove they satisfy the due diligence criteria. Before entering a position and in an ongoing manner, E.U. banks must demonstrate a thorough understanding of any given deal and that they have implemented "formal policies and procedures… commensurate with the risk profile of their investments in securitized positions" to analyze and monitor any exposures arising from the performance of the collateral underlying a deal.

This demands both a backbone to unify the necessary portfolio management and risk management activities, but also the operational sophistication and business-wide controls to establish due diligence processes and maintain compliance with internally established investment guidelines.

Failure to comply with these requirements results in additional capital risk weightings. Depending on the severity of the breach, anywhere between a 250% to 1250% additional risk weighting can be applied to each asset per breach. The latest revisions have given national regulators discretion to apply weightings as they see fit. An E.U.-wide review of the implementation of these rules in 2012 will create continued uncertainty and challenge institutions to have the flexibility to incorporate any changes to practical requirements of Article 122a, for example, relating to updated criteria for different asset classes. This is particularly important as unremedied infringements will incur additional penalties over time.

Before investing

Know Your Seller

Article 122a states that an investor must understand and ensure that an issuer discloses details of a minimum 5% net economic interest in any new securitization, both upfront and on an ongoing basis.

For asset classes like credit card ABS where retention already has some precedence, this may be an easier task. One of four methods is available to issuers (three involving exposure to the securitization and the other exposure to randomly selected receivables from the same pool). Investors must understand how the originator has retained an interest and ensure there is initial and ongoing disclosure. Statements or disclosures regarding due diligence on the underlying collateral must also be tracked, with evidence they have been acted upon where necessary.

In addition, penalties will be applied if a credit institution shows it hasn't understood the reputation and loss experience of an originator in earlier securitizations. This can be monitored relatively easily but it is imperative to set up and maintain a view of this over time within a credit institution's due diligence system.

Risk Characteristics

Understanding the risk characteristics of individual tranches means monitoring issuance details, such as

seniority level, ratings, cashflow profile, historical performance and credit enhancement.

Pre-crisis, portfolio managers would often look at investments on a quarterly basis. Extracting granular data was a manual task, with deals presented in multifarious formats. It was common practice to book and manage securities as vanilla, fixed-income assets on core treasury systems. Spreadsheet-based systems were often used to store the basic data needed to support monthly cashflows. Even for investors with the capability and inclination to perform additional analysis, the variance in issuer disclosure and less available performance data in the E.U. meant understanding a structure in the way seen acceptable today was often impossible.

Investors should seek consistent ways to analyze and manage all of the data relating to a deal's structure and credit enhancement, the individual tranches of that deal and the performance of its underlying collateral pools. For a credit institution with growing exposures to different securitizations, finding a way to consolidate the various data points for deal information and performance data across assets, so it can all be seen in one place, provides a basis for sound investment analysis and comprehensive risk management for individual assets, portfolios and across parent operations.

Structural Features

Beyond definitions of risk characteristics, investors must also understand the structural features of a deal, such as the waterfall, transaction triggers, embedded hedging instruments or liquidity facilities.

A cashflow waterfall provision is being touted with the **Bank of England**'s Discount Window Facility criteria. The **European Central Bank** and BoE have also indirectly increased pressure to provide loan-level and collateral performance information. In **Principia**'s 2010 investor survey, investors stated that the ability to capture and model the structure of a securitization in their systems when analyzing individual deals was the second most important aspect of due diligence. Over 50% then stated that they were not effective at modeling the full deal structure, neither by independently interpreting issuer documentation nor through the use of third-party data providers. Clearly this has to change.

A detailed understanding of the waterfall structure and strong cashflow models alongside accurate, timely performance data leads to informed and independent assumptions about the future behavior of assets and proof of an independent assessment of the valuation. Investors need to have the integrated cashflow models, performance data and analytical flexibility to forecast future performance for all the securities they hold, as well as for any potential investment.

Risk Characteristics: Underlying Exposures

This requirement does not specify that investors track each loan underlying a deal. Rather, it defines collateral pool characteristics and stratifications, depending on the granularity of underlying pools and the asset class under analysis. The **European Banking Authority** guidance highlights key performance indicators that should always be considered, such as delinquency, default, prepay and foreclosure rates and other metrics like pooled credit scores and geographical diversification. Investors need to have the clarity and ability to make assumptions based on pool performance exposures most relevant to each transaction type.

If the risk profile of the deal requires analysis of individual loans, that must form part of the due diligence process. But it is not a requirement each time. Ensuring comprehensive asset coverage and the comparability of performance measurements across asset classes, geographic regions and sectors is a major operational challenge when ensuring comprehensive credit analysis. The difficulty of incorporating performance data for multiple deals and asset types, from multiple internal and external sources and normalizing it for consistent analysis can be operationally complex and resource intensive to set up and maintain. Implementing a flexible infrastructure to consolidate this analysis sits at the heart of satisfying the requirement effectively and with ongoing confidence.

You Diligence

Where relying on third-party financial models, credit institutions must run equally adequate models, with the ability to change inputs and stress levels as appropriate. For each asset, being able to layer in model assumptions to independently verify and project future valuations is imperative. Institutions require the systems flexibility to be able to first see a complete view of the deal and its performance to make strong assumptions and then apply these to a cashflow model, both initially and then in an automated way as the deal changes over time.

Procedures to analyze and record the methodologies on which the valuation of the underlying loans are based must also be in place if an individual loan could have a big impact on deal cashflows, for example a loan in a commercial mortgage-backed securitization. This

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