Seeing the wood and the trees

Douglas Long, evp business strategy at software provider Principia, discusses how addressing investor due diligence requirements today demands operational control across the entire credit investment business

Ask what is meant by ‘investor due diligence’ and you’ll likely get a host of different answers. The term’s openness for interpretation has meant that the simplest definition gradually became the benchmark in years past.

It was seen as a basic level of care, commensurate with the perceived demands of the powers that be. During the meteoric rise of structured finance, the true sentiment of the term got lost somewhere.

Perception is a funny thing. ‘Due’ was interpreted in the context of the cycle we were in. Only the minimum necessary checks were needed to satisfy investment guidelines or to verify independent credit performance and cashflow assumptions.

Third-party assessments, usually through ratings, were trusted and seen as adequate for appropriate care. Their opinions alone seemed sufficient.

Today, ‘due’ is placed in the new world concept. Investors would be unanimous in agreeing that due diligence now demands comprehensive and in-house credit analysis, risk management from the collateral performance level up and an array of activities related to the initial and ongoing understanding of structured finance assets and portfolios.

An investor has to perform an appropriate level of due diligence for every position entered. Third-party opinions cannot be used alone to make investment decisions and monitor their risks.

In January 2011, Article 122a of the revised EU Capital Requirements Directive went live, imposing a direct responsibility on investors and issuers to perform an adequate level of due diligence for any securitisation transaction. Hubris continues to overshadow important technical considerations that are fundamental to an organisation complying with new investor requirements.

Directions are given in the implementation guidelines of Article 122a by The Committee of European Banking Supervisors (CEBS), now the European Banking Authority (EBA). However, implementing those considerations across the credit investment operation amidst a complex network of systems, information and processes to comprehensively and assuredly satisfy the regional supervisors is no small task.

Much focus is placed on understanding ABS, MBS and CDO investments on a deal-by-deal basis, but for a credit institution investing in these securities, due diligence is not only a deal-by-deal job. It requires a portfolio- and business unit-wide operational approach to understanding

investments in context, alongside detailed and thorough deal analysis. Without this, credit institutions won't be able to see the wood for the trees.

Before entering a position and in an ongoing manner, EU 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 securitised positions' to analyse and monitor any exposures arising from the performance or collateral underlying a deal. This demands a strong 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 internal investment guidelines.

Depending on the severity of a breach, an additional risk weighting of anywhere between 250% to 1250% can be applied to a securitisation exposure. A revision to risk-weighted penalties in the latest guidelines also states that the regulator "shall increase the risk weight with each subsequent infringement" over time. The penalties are now clearly outlined in national supervisor's implementation handbooks too; for example, the FSA's Handbook, BIPRU 9.15.16R.

What's an investor to do?

Monitor and track risk exposures

At the deal level, understanding the risk characteristics of individual tranches means monitoring issuance details, such as seniority level, cashflow profile, historical performance and credit enhancement.

Diligent investment analysis under today's CRD means implementing consistent ways to analyse 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. To avoid penalties, large credit institutions with growing exposures to different securitisations will need to find ways to consolidate the various data sets for all the deal information and performance data across its assets. This is the basis for sound investment analysis and risk management for individual deals, but also for effectively managing the entire portfolio and reporting to parent operations.

Know the structure

Investors must also understand or be able to analyse the structural features of deals, such as the waterfall, transaction triggers, embedded hedging counterparties or liquidity facilities.

A detailed understanding of the waterfall structure and strong cashflow models, alongside accurate, timely performance data is a pre-condition to informed and independent assumptions about the future behaviour of assets and proof of independence. 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. This demands the operational backbone to efficiently and consistently bring together all of these elements and incorporate internal credit research within a single view of credit and market risk factors surrounding the structured finance and fixed income business.

Underlying exposure statistics…and loan level if you have to

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.

If the risk profile of the deal requires an investor to analyse individual loans, then that must form part of the due diligence process but it is not a direct requirement each time. The EBA 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 the clarity and tools to make assumptions based on the pool performance exposures most relevant to every transaction type.

Ensuring comprehensive asset coverage and the comparability of performance measurements across asset classes, geographic regions and sectors is a major operational challenge in ensuring comprehensive credit analysis. The difficulty of incorporating performance data for multiple deals and asset types from multiple internal and external sources and normalising 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 confidence.

In-house due diligence
Where relying on third-party financial models, the credit institution must be running equally adequate models itself, with the ability to change inputs and stress levels as appropriate. While deal analytics providers provide tools like this for the assets they cover, a credit institution looking to analyse across the breadth of its structured finance and fixed income securities will require an integrated way to calculate future cashflow across the entire portfolio. Analysing different asset classes in isolation leaves gaps and analytical limitations when attempting to perform due diligence at the portfolio-wide level.

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 their assumptions to a cashflow model, both initially and then in an automated way over the longer term. Importantly though, this needs to be performed across all assets and data sources within a single environment to make fully informed investment decisions and proactively manage risk exposures.

On an ongoing basis…
All the information and calculations needed to make independent assessments over time must be accessible on-demand in a timely and comprehensive way and recorded for reporting purposes. Credit institutions need the operational rigor to see everything at once, bring in all the information required for analysis and then - with a fully informed view of the detail - have the confidence and tools to layer in assumptions regarding stressed scenarios.

Stress testing appropriate to each securitisation position is key to satisfying the requirements. Doing so also provides an ongoing framework for due diligence when combined with the establishment of operational guidelines, risk limits and controls.

Stress testing portfolio sensitivities and collateral performance exposures requires that there is first a view across the breadth of risk exposures and an ability to define and analyse any combination of exposure parameters. Alongside the consistent integration of cashflow models and data, stress testing by business line, portfolio exposure (e.g. asset type, geography, sector, ratings etc) or performance exposure (e.g. delinquency rates, default rates, prepayment rates, foreclosure rates) can be sustainable and complete.

Warning flags can be set for the most appropriate metrics of each asset class to automate early risk signals at the collateral, deal and portfolio level and highlight exposures demanding more in-depth analysis. Future valuations can more effectively be projected under many different scenarios to inform prudent choices across the entire structured finance business.

The original Basel 2 enhancements to the securitisation framework phrased due diligence as 'operational credit analysis criteria'. While credit institutions must prove they know every investment to satisfy the regulators, today they must also demonstrate they have the full operational sophistication required to do so, across all deals, portfolios and business lines.

Then, if a tree falls in the wood, you can be there to find out if it makes a noise or not.

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