

# BACK TO BASICS

We take you back to the credit basics to review everything you thought you already knew but were too afraid to ask...

**Douglas Long, EVP of business strategy at software firm Principia, explains how structured finance portfolio management techniques have evolved in the current market**

THE PROFILE OF structured finance investors has changed dramatically during the current liquidity crisis. The traditional buyer base, dominated by off-balance sheet SPVs, has been supplemented by two new categories. Firstly, distressed debt investment funds and hedge funds, which are being set up to actively purchase ABS, MBS and CDO assets and take advantage of the currently attractive spreads and the overhang of product availability. Secondly, those players that, either through necessity or by choice, are taking more assets onto their balance sheet. For example, many SIV equity investors have taken on the management of a large number of the SIV assets during this wind-down period, as they close out each SIV investment through a process called vertical slicing.

Prior to this shift, sophisticated structured finance portfolio management techniques were adopted by specialised off-balance operations such as SIVs, due to the imposition of the rating agencies' strict surveillance, operating guidelines and compliance requirements on their management. The crisis, however, highlighted the need for a broader integration of such techniques into the management and administration of all structured finance portfolios.

## Portfolio management techniques

With large-scale ABS/MBS asset redistribution, such techniques need to be within an operational backbone that has the proven capacity to support the efficient management, control and ongoing surveillance of both on- and off-balance sheet structured finance portfolios. Many financial institutions have identified this time of transition in the market as an opportunity to enhance the entire process and adopt industry-leading best practices. The main areas being addressed include:

*Underlying collateral:* Greater transparency is required on the underlying collateral backing the asset investments and the integration of this into credit analysis. Existing and new data providers, like Intex, ABSNet and Markit, are expanding their coverage and cashflow modelling capabilities.

*Performance:* Reliance on asset ratings alone is insufficient and it is critical to continually monitor deal and underlying collateral performance information. This information is often collected from a variety of different sources and supplemented with internal credit analysis.

*Consolidated portfolio view:* With off-balance sheet asset exposures moving onto the balance sheet, financial organisations are confronted

with the challenge of gaining a comprehensive perspective over all of their investments. The need for oversight has emphasised the importance of accurate risk profiling alongside equally critical reporting capabilities necessary for the management and accounting of these complex securities.

*Surveillance and compliance:* The ability to perform consolidated risk analysis and ongoing portfolio surveillance has become of paramount importance – further complicated by demands for transparency from all interested parties, both internally and externally. To do so, compliance and limit provisions are being placed on individual as well as consolidated portfolios. This ensures diversity and that the portfolio is within the group's pre-defined risk limits.

*Operations and accounting:* Despite the new market demands outlined, the requirement to have efficient operations in place to manage these complex assets through to accounting remains just as crucial to success as ever. The challenge is to have a truly transparent approach in place that consistently integrates the portfolio and data management requirements into the ongoing surveillance, compliance, trade approval and accounting process. Undoubtedly these operations will be greatly influenced by the anticipated changes to corporate governance, regulation and accounting standards – and successful market participants will be those that have the capability and readiness to adapt and evolve quickly.

For on-balance sheet operations in particular, institutions need a true and transparent infrastructure for asset portfolio management. The use of existing treasury systems or building bespoke spreadsheet solutions is no longer sufficient to meet the subtle and specific needs of compliance, surveillance, operational control, risk management and accounting for structured finance portfolios.

## The road ahead

The structured finance market is here to stay – but exactly how it will evolve to meet new circumstances is unknown. The industry will continue its march towards increased compliance and surveillance while regulatory and industry bodies introduce new reporting, disclosure and accounting standards. The only way to manage this change effectively and make the most out of new opportunities will be to have a strong and flexible operational infrastructure securely in place. This will help foster a robust industry architecture that can in turn influence the next successful cycle of economic growth. ☉