DOUG LONG

The business strategy head at structured finance software vendor Principia talks to Matthew Attwood about what it will take to restore investor appetite for structured products

***Matthew Attwood, editor, Credit*: Will demand for highly leveraged structures come back?**

Doug Long, executive vice-president of business strategy, Principia: If you're willing to accept the risks as an investor, you can go out and get everything you want. If you're a specialised investor and you want that leveraged-up risk, there are boutiques who will allow you to do that. The problem is that spreads got so tight that leverage infiltrated everywhere. Specialised investors will want increased returns, for which they'll be prepared to take on the risk. It won't be wholesale – maybe it will be bespoke and unrated – but if you want to take that risk and push the boat out, people will do it for you. It's not a bad thing; it's a bad thing when everyone does it, but not if you understand the risks. The wholesale leveraged business won't come back, though.

Going into the first quarter, what do you expect for Principia?

We expect a pick-up in interest from players looking to get back into the market by purchasing structured finance assets, those that have made the decision to move forward. We see people getting ready to do that with the view that asset prices will be hitting a bottom in Q1/Q2, especially in the light of some of the other measures the Fed has announced, such as buying up Fannie and Freddie's MBS and providing top-tier triple-A support for ABS consumer finance securitisations.

If these measures work, they will kick off interest in buying the products and allow that market to start issuing again. Ultimately that will provide the pricing required for people to get back in, not that it will be a flood. It'll be for those who see it as the right time, who've seen some uptick in prices over a period and who truly believe the bottom's been hit. I'm sure they don't care about catching the exact bottom, they just want to make sure they're in it when it's nearish the bottom and is only going to go one way and pull back to par.

That's the initial focus for us. The second major thing is adapting and responding to changes in the regulatory environment.

And your role in that is to advise on how the regulation affects your clients?

Partly, but our clients are generally very sophisticated and keep track of what's going on in the market. But what they need is the right tools to adapt and work with it. They need to adjust their business models, reporting requirements, incorporate additional information and controls and implement that in their operation. It's about systems as well as people. We're trying to be one step ahead so they have all the tools available to them, but it's up to them to decide how they apply them.

So with those clients who think we're nearing the bottom, how does the relationship proceed for you?

Say it's a credit investment group within a bank, on balance sheet. If they're new to the market or possess a portfolio they wish to expand, they need certain things to run the business: they need to look at and manage their portfolio, they need control of who's allowed to do what and what trades are allowed to be done. In the light of the crisis they also need to ensure that the risk surveillance guys have strong control of those functions, so when a trade is done they get notified, and that it's all audited, checked and tracked.

The second thing is when they launch their business they get pre-approved mandates on what they're allowed to do. So they say we're going to buy only triple-A securities backed by a TARP-like plan, or by Fannie and Freddie. We can incorporate that into the structure. They need to be able to say these are my compliance requirements, and be able to prove with every new deal that they are managing to that. Previously that has very often been manual and operationally burdensome but it's something we hope to automate.

And what about portfolio oversight?

The key thing is ensuring that a portfolio is managed on a dynamic basis – these are dynamic securities and require different data from different sources, so if they're a European asset, the leading data provider might be Lewtan, so Lewtan will provide details on performance. If it's a US security they'll want to link in with Intex or some other product and bring in that performance and security information. They want an automated process that presents quickly a clear view of a portfolio whenever someone wants to look at it, be it end of month or *ad hoc* management reporting.

The final thing is making sure that those securities flow through to your accounting and that you can sit alongside the core treasury system and consolidate the pieces; when you're managing a portfolio you'll be hedging your instruments out, maybe figuring out the funding requirements you need, and doing that alongside your core treasury system. It's the boring bit of the operation that people don't necessarily think about first. It's great having a front office tool that allows you to structure a security, like Intex, who do a fantastic job in structuring and doing different stress-testing. But once you've made a decision, you need to control that for the rest of the lifecycle. That's the key lesson people have learnt – it's more than just an initial investment decision and putting it into your portfolio, it's the ongoing management of the whole business.

> "As primary issuance comes back, you'll find buyers with the infrastructure to manage structured assets, but it will not be like the end of 2006"
>
> Doug Long, Principia

What assets will your clients be looking at right at the beginning?

If you're an experienced distressed player who really understands the structures and the fundamentals versus the market price, you don't really care about the complexity of the structure as long as you have a view on the likely outcomes. You'll in fact find more value in the complex products because there are less people active at that end of the market.

There's clearly a tiering in terms of investor sophistication, and as you say the most value is at the less contested, complex end of the market, so there'll be a greater number of bids for a straightforward securitisation than for a CDO?

Yes. The key thing is that there will always be specialist investors who understand the complex products and how they behave, and the more mainstream who will grasp the simpler ones more easily.

With obvious consequences for liquidity and thus pricing at that end of the market.

Yes.

Are the sellers going to be in a position to get a better price at the less complicated end?

That depends on the structure. But the simpler the structure the more people will be likely to participate. Liquidity will not come back for the more complex stuff until the simpler structures themselves have become a lot more liquid and easily accessible. We're talking a long time off as well: you'll still be paying a big liquidity premium in 2009 for almost every asset, it's just that on some it'll be a smaller premium than others. But all will be a long way off from where they were in 06/07.

Are people likely to hold these things to maturity?

That's where you get the great pick-up from buying in distressed conditions. With a pullback to par, depending on the weighted average life and if you can anticipate any defaults coming through on the more distressed or credit-sensitive securities, then there's no reason not to hold assets to maturity.

But again you've got hedge funds versus investment funds, and hedge funds will probably be a bit more sensitive to where the market goes. They may look to sell things in a shorter timeframe, whereas investment funds will be looking to get in early, lock the money up, take to maturity and get good returns that way.

Is any of this money leveraged?

I think some investment funds are considering offering several different buckets – some with zero leverage, some one or two times. It really depends. A hedge fund needs a certain level of return, pure and simple, and if they can't find the product to get it with no leverage, they have to get leveraged up: there's no way around that. As the market stabilises a bit more and prices come back to some level of normality, I believe the focus will move away from hedge funds in terms of new entrants and towards long-term investment funds that will, without as high a leverage, be able to participate.

And that will be a function of credit committees becoming more comfortable with these assets and responding more positively when a portfolio manager says he's keen to buy this stuff?

You're going to have to get buy-in from almost every level of management into these securities. But we're seeing pension funds come through and actively looking for these type of security funds because they see value where they are now, they've got the duration and they can sit pretty. And they have cash they need to put to work, and to get more than just a Libor or Treasury yield.

Let's talk about marking to market. Some observers have blamed this discipline for the credit crisis. Was it the case that marking portfolios to market value was potentially dangerous and would in itself become a driver of prices?

In hindsight, marking in certain situations was one of the big drivers, but the reality is that everyone was pushing prior to this, with the introduction of FASB, for good ways of getting transparency on off-balance sheet structures. And part of that is knowing the value of the assets in there. I think one of the lessons to be learnt is the tiering of different pricings – Level 1, 2 or 3 – because that allows you to understand more about the quality of those prices. So if your entire asset portfolio is Level 1, you're pretty sound, but if 20% or 30% is Level 3 you're more cautious about it because you know it's illiquid and the pricing is based on internal controls and models – possibly some very general assumptions – to get a market price.

So you need something less simplistic than a simple trigger?

Market value structures, separate SPVs with pure market value triggers, just don't work. They're fine in normal markets but when you hit the stress – and the stress this time wasn't purely about structured finance assets, they were just the first pin to drop – as soon as you hit the stress, with correlation moving to 1 and all prices moving the same way, it's damaging to have such a hard and fast rule.

In a hypothetical future when structured finance comes back in a basic way, what level of understanding will structured credit investors need?

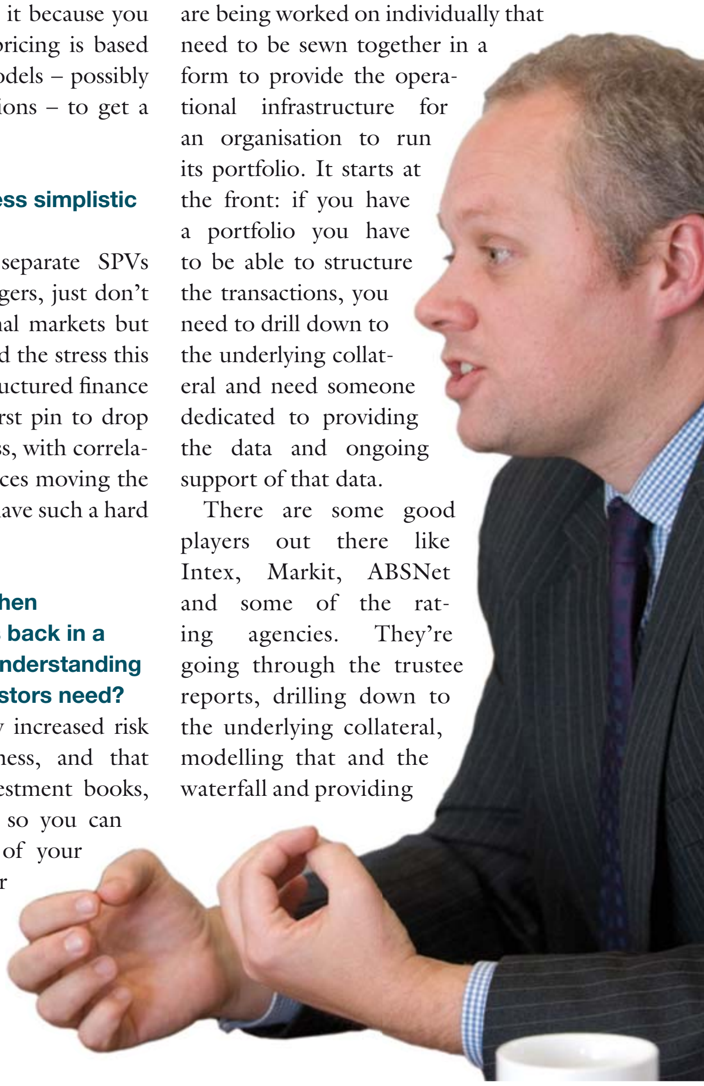
First, you need significantly increased risk oversight across the business, and that includes the individual investment books, on- and off-balance sheet, so you can very quickly get an idea of your overall exposures within your business unit and across business units. A lot of organisations lacked that previously.

Then you need very clear understanding of the products you're investing in. And that's appreciating the structure and the subtleties within it, as well as the risk you're exposing your organisation to.

The third thing is having the right accounting and operational treatment of those. If you are sophisticated and invest in sophisticated structures, you need a control in place to manage these products through their lifecycle and to account for them in the right way, whether they're Level 1, 2 or 3.

We're at the beginning of this. A lot of people have been in the structured finance market for a long time but this new drive to bring a level of sophistication to everyone involved is new. Before there were pockets within groups that had sophisticated systems and had the right controls but it wasn't universally adopted. What investors were looking for wasn't standardised. Many pieces are being worked on individually that need to be sewn together in a form to provide the operational infrastructure for an organisation to run its portfolio. It starts at the front: if you have a portfolio you have to be able to structure the transactions, you need to drill down to the underlying collateral and need someone dedicated to providing the data and ongoing support of that data.

There are some good players out there like Intex, Markit, ABSNet and some of the rating agencies. They're going through the trustee reports, drilling down to the underlying collateral, modelling that and the waterfall and providing



ongoing performance information – all the information you would need to make your initial investment decision and also for ongoing surveillance of it.

Are any of them close to providing a universal measure of systemic risk?

No, that's the key. These are data providers and they're great at doing at what they do but looking at systemic risk is the responsibility of investing organisations, to collate all that data for all their portfolios and be able to stress-test for all those different scenarios, looking at the risk of your exposures and making sure you're operating within the limits of your compliance procedures or what's been mandated to you by external bodies. A lot more systemic stress-testing has to be performed, you have to understand a lot of future scenarios and a lot more work has to be done as a management team managing the portfolio – not just looking at your distribution and risk sensitivities but taking a step back: what happens in this scenario? Where is our biggest risk? What happens if that market crashes?

How do you reconcile that with the fact that all these institutions are competing in a market?

The good thing is that there are industry bodies progressing on that front: the ESF and ASF for example are almost providing a standard interface, and then you have the data providers who are trying to supply full coverage to their clients. You also have people like ourselves who hope to provide a way of consolidating that into a single platform.

How has your business shifted over the course of the crisis?

Before, we'd talk about the sophisticated managers of structured finance assets. When you were looking for sophistication in risk control, compliance requirements and operational management of these products you have to have a good reason to justify buying systems and investing in infrastructure. So traditionally, we relied on those sophisticated players, which were generally SPVs sponsored by banks for on- and off-balance sheet structures. They appreciated that sophistication and were mandated to have it by the rating agencies and sponsoring banks. That was our focus before the crisis.

Now everything is done on-balance sheet. The barrier to entry for people who need to manage these products has changed across the board. The move to on-balance sheet management has broadened our market considerably: credit investment desks within bank treasuries, opportunistic distressed debt funds and insurance companies with investment portfolios they need to manage. Before they either relied on internal development – databases they built themselves – or their existing treasury systems. The market needs what we've been providing for years.

No-one in their right mind would enter the market now using the techniques we used two or three years ago.

What happens if, in years to come, spreads contract and people – maybe with short memories – start to ask again how they can eke a little extra out of the market?

Something like that will happen in the future, and having the right safeguards and legislation in place will help to control that. The whole point of having a market is for it to be efficient, and for arbitrage opportunities to be nipped in the bud. Without that, you get the illiquidity and inefficiencies. Short-term, there will be a contraction, an overhang of assets. People have to start buying them, they'll sit in a buy-and-hold strategy and depending on the price at which they buy them, they'll make money or lose money.

Then, as the primary issuance market comes back, you'll find buyers with the right infrastructure to purchase and manage assets, but it will not be what we saw at the end of 2006. It'll be simple structures that people can understand, and the infrastructure will be there to support those structures. Spreads will come down to an appropriate level – not to what they were in 2007 – and when you have a standardised set of products people will innovate. We are in a different world now; things that were allowable two years ago – I'm talking about the economics and the ratings process – have been shown not to work.