

By Dr. Douglas Long

The Buy-Side Wakes Up

Investor interest in ABS is back, according to a survey conducted by Principia Partners. But in an industry known by outsiders more for its hubris than its humility, many bondholders admit that they are now ill-equipped to invest in securitized products. In the post-crisis world of intensive regulation they will have to raise their game.

What's on an asset-backed securities investor's mind? Some three years after the U.S. mortgage market meltdown started, many think it's time to get more involved again. But doubts still linger — and not just about the state of the market and the impact regulation may have on securitization. Many investors remain skeptical that they have all the tools they need to do their job.

These are two of the salient findings of an investor due diligence survey of more than 500 structured finance market participants from 200 financial organizations that Principia Partners conducted during the second and third quarters of 2010.

First, the good news. Our results show that more than 60% of European and U.S. investors intend to increase their investment activities in mortgage bonds and other asset-backed securities by mid-2011. Granted, bondholders feel more bullish in the United States as 63% of non-bank investors indicated they were ready to jump back in, a full 15 percentage points more than their European counterparts (see exhibit 1).

That is to be expected. In part, it is influenced by the continuing turmoil caused by sovereign debt crises across the European Union. But it is also a reflection of how securitization was still in its relative infancy before the crisis hit. Even now, there is a less robust market infrastructure in Europe. It is, for example, much harder to get hold of loan level data and cash flow models than in the United States.

Perhaps more significant, though, is the candor with which respondents describe their own shortcomings as investors. Over 60% of global investors said they were less than effective at performing the priority tasks listed in exhibit 2 for investment analysis. Digging down further, 78% of EU-based investors and 72% in the United States stated that they were not effective at or well prepared to integrate and access loan level data. Only 49% of European bondholders said they could effectively model the cash flows for the bonds they held, compared with 48% across the pond. This, of course, has implications for the important risk management tasks such as forecasting cash flows based on performance assumptions and gaining a consolidated view of risks across portfolios.

Labor Intensive

How times have changed. It's fair to say that a large chunk of investors before the crisis in asset-backed securities were not performing in-depth analysis of the securities they were buying, especially if they were only buying triple-A-rated paper. Often portfolio managers would only look at their investments once a month when the reports from trustees came in. Extracting granular data from indentures was manually intensive. It was common practice to book and manage securities as vanilla fixed income assets on treasury systems. Spreadsheet silos stored the basic data to support monthly cash flows. Even for investors with the capability and inclination to perform additional analysis, the variance in the level of issuer disclosure, or lack of it, and the difficulty in accessing or making use of detailed loan level data meant that truly understanding a structure was highly labor intensive.

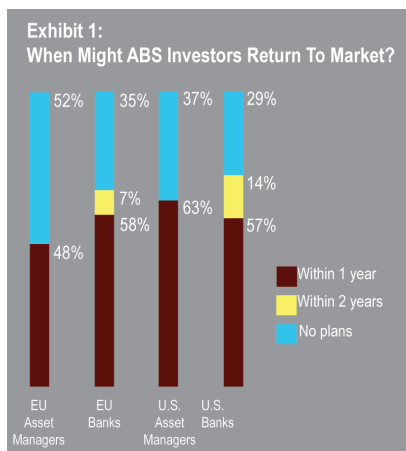
The crash changed all that. Bondholders, of course, have learned the hard way that they need to pay more attention. But investor due diligence is now a regulated reality, too.

It is much more direct in Europe. Thanks to the amendments to the EU Capital Requirements Directive that went live in the eurozone at the start of this year, capital penalties now apply if investors do not meet specific operational requirements in analyzing newly issued asset securitizations and resecuritizations.

International regulators are committed to applying these measures, forcing financial institutions to have properly established systems and controls in place to demonstrate that the proper level of due diligence has been carried out for structured finance investments and portfolios. The tenor of the rules is clear: a box-ticking exercise is not sufficient.

In the United States, for now at least, the Dodd-Frank financial reform act and the Securities and Exchange Commission's revamp of Reg AB more directly target issuers, mandating them

to provide greater disclosure. There is no direct ruling forcing investors to



perform due diligence yet. The Federal Deposit Insurance Corporation, the Federal Reserve and the Office of the Comptroller of the Currency began a market consultation in December 2010 about proposed rule changes that will introduce capital rules in line with the Basel II Securitization Framework Enhancements and demand bank investors prove an adequate level of due diligence. Currently, though, a reluctance to provide full backing to credit rating agencies or use external ratings within the regulatory framework is a clear sign that investors must perform much more independent credit analysis. It is only a matter of time before investors will need to demonstrate that they truly understand the securities they invest in.

U.S. investors in our survey rank the ability to model the entire deal structure as the most important analytic tool, closely followed by being able to access collateral performance data throughout the life of all the deals they hold. Along with the ability to forecast cash flows based on assumptions of changing dynamics at the deal, tranche or collateral level, these activities are now fundamental aspects of an investor's work.

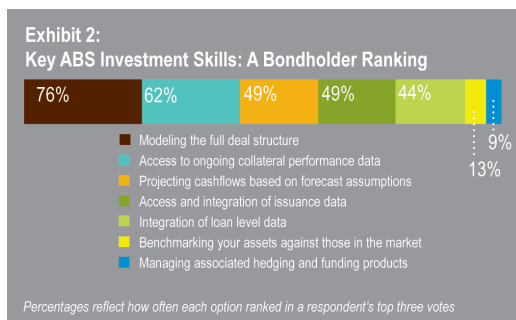
EU investors have the biggest room for improvement. For example, 70% said they were not effective at stress testing forecast assumptions across their portfolio, compared with 50% of U.S. investors. Performing these key activities relies on the availability of underlying information, but also the operational capacity to consistently integrate and manage it for regular analysis.

Data availability alone, though, is clearly not the panacea for investors. Loan-level data and analytical tools were available before in the United States, but did not shelter the market from the storm that ensued. Now, even more data is to be made available, thanks partly to changes implemented by the market such as the American Securitization Forum's LINC, and also to im-

pending regulatory changes. But many investors concede that it will be a big challenge to fully integrate more commoditized, voluminous data, into a sustainable long term structured finance operation. As investment volume increases, investors want to be able to focus on their core business rather than spend a disproportionate amount of time collecting data or reverse engineering loan level information and waterfall structures.

It's not necessarily a matter of beefing up their analytical systems to cope with the increased flow of information, but rather having the operational infrastructure to more effectively tie together data, investment analysis processes, risk surveillance and the way this information can be accessed and manipulated for accurate and comprehensive reporting.

Many investors gave the impression that their systems lacked this operational coordination before the crisis. Almost three-quarters of U.S. respondents revealed that they still rely too heavily on spreadsheets, for example. Having to manually input much of the information is also a cause for concern: some 69% said they were not effective at reducing the inaccuracies inherent in using such a patchwork of systems from front to back office or for different asset classes. The inefficient integration of multiple systems used within many investment firms was another hindrance cited time and again.



United States Ahead of Europe

These are worryingly high numbers. The good news is that the U.S. market, which has returned to life sooner than Europe, has a more mature infrastructure to confront these concerns.

Anyone investing in structured finance in 2011 and beyond — even triple-A investors — will require a thorough understanding of, and an effective way to manage and monitor, the cash flows related to the securitizations they invest in. Whether to satisfy the regulators or to make confident investment or divestment decisions, this will be vital. Less reliance on external ratings will expose organizations to the operational shortfalls uncovered in Principia's study.

As long-term, buy-and-hold investors start to return, those who are empowered to do more with all the information available will have a competitive advantage. Streamlining operations will free up the resources to focus on the core business of investment and ensure the vital aspects of risk surveillance can be performed with confidence. With the limitations and risks of operational inefficiency relegated to the periphery, a scalable business centered on structured finance can again become a reality. ▼

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