TRANSPARENCY IN SIGHT

The liquidity crisis has reinforced the importance of transparency in the structured finance market and focused minds on improving operational efficiency. **Hardeep Dhillon** looks at back-office operations and initiatives aimed at rebuilding investor confidence and boosting transparency in ABS markets.

FEATURE: BACK OFFICE

The structured finance market's retrenchment after the summer's liquidity crisis is prompting participants to review of all aspects of their operations and reinforcing the importance of transparency in order to rebuild confidence. Systems and infrastructure integrity, risk management, portfolio valuation, data dissemination, pricing and reporting are all coming under the spotlight.

"Discussion in the ABS market about the importance of transparency has just started. This crisis is not about the credit quality of most asset-backed securities but investor confidence in general," says Dagmar Schemann-Teuber, managing director of ABS+MBS Consulting Schemann-Teuber. Compared to before mid-2007, she hopes that investors will now have somewhat more influence to force all other parties to focus more on due diligence and risk management, and also the middle and back offices. "Otherwise we can start discussing when we expect the next ABS market crisis after this one," she says.

One product marketing manager at an ABS technology provider, says there is anecdotal evidence that focus is extending to all aspects of middle- and back-office functions. "Any tools that can give a better insight on the state of the market and on what has value are being used from surveillance services, market data feeds to data warehouses," he says.

There has been a growing move in recent years from internally built or spreadsheet type systems to robust third- party applications that provide independence in the monitoring process and reporting framework. Douglas Long, executive vice- president, business strategy at Principia Partners, believes that analysing the structure and the risk of instruments, and assessing the manager on products or those running structured finance businesses, will push the onus onto a lot more participants to manage their entire operational structure. "A key challenge will be to have the flexibility to be able to adapt quickly to what the market's requirements and needs are," he says.

The Principia Structured Finance Platform (SFP) provides the management and administration of structured finance operations and structures, from and covers deal capture, compliance reporting and accounting. The solution supports a host of business types including securities arbitrage conduits, CDO collateral managers, MBS/ABS investment funds to ABCP conduits and structured investment vehicles.

"For many, SFP is the single system and the backbone for running their structured finance operations. There is no doubling up on systems or having to invest in additional software in order to incorporate other types of product in the markets as it is all integrated into one solution that can link with external services that provide the structuring, such as Intex," he says.

Philippe Carrel, global head of business development at Reuters Trade and Risk Management, believes that risk management processes will require front to back-office consistency from the underlying data to the final output. Transparency will still be key, he adds, and require not just transparency of data, but also of positions, processes and methodology. "It will not be a case of simply looking at a valuation but at the guarantee that prices are properly calculated, at the underlying methodology of how prices are derived and finding consensus in the market," he says.

He believes that third- party intervention is necessary to provide neutral and unbiased views and to make sure the proper data is available to facilitate trading. Indeed, he sees a growing number of firms viewing the rationalising and streamlining of data management as key to operational risk and cost mitigation. Many are becoming more interested in enterprise data management (EDM) systems and technology to provide confidence and trust in data, he adds.

Reuters' Enterprise Data Management solution and the Reuters Enterprise Platform (REP), provides full automation for sourcing, cleaning, aggregating and distributing market, reference and other data from external and internal sources. By distributing the cleansed data to downstream applications and users across a firm, REP allows clients to improve the management and efficiency of trading and operational risk, while reducing infrastructure complexity.

"Focused on integration, REP is the backbone for integrating data on a single real-time interactive platform for the front-, mid- and back-offices services to use," he says. With regards to financial models and valuations, Reuters will move to an open model strategy in 2008 that is a different approach to current mathematics and modelling. "It will be a consensus approach combining everything a client needs from data to models, methodology and research. We are not advocating what is the right or wrong approach but leaving it open to what the consensus is," he says.

The product manager states that the integration and harmonisation of banking systems has failed to keep pace with operational integration, as often, individual information

Angheben: there is an ongoing standardisation effort

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Long: Impetus for increased transparency for all products

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platforms grow in isolation and have limited interaction with other platforms. This leads to very advanced systems that efficiently perform one function, and a black-box syndrome, where knowledge of applications becomes concentrated in sparse human resources.

Though not thought to be a problem in a bank as a static, going concern, this would pose new problems when mergers and acquisitions enter the picture. Thus, in general terms, banks need to harmonise and rationalise their information systems. This would require documenting information flows across the bank, surveying the information interfaces of the bank, where data enters or exits the bank's systems, and identifying those human resources critical to the continued operations of the bank.

The objective of this exercise should be to determine where there is operational overlap, to identify chosen platforms, and eliminate redundancies. "All banks have gone through tremendous organisational changes and their approaches are very different. The objective is trying to rationalise and reduce the redundant points of data wherever possible to make sure you are operating as efficiently, with as little few possibilities as possible to create systemic errors," he says.

Highland Financial Holdings Group has improved its operational and risk management by developing an in-house back- and middle-office architecture for the net asset value calculation process of its MBS and ABS assets. Due to the complexity of such instruments, their valuation is difficult and the in-house solution was developed as the fund did not feel comfortable outsourcing to a third-party service provider.

In contrast to exchange-traded and other OTC instruments, the structured finance market has lagged in terms of sourcing information from multiple and different venues in a consistent way. The product manager argues that transparency is the ability to report, access data and provide information to investors on a timely and regular basis. In addition, operational transparency is required, such as providing information to the internal management team or sponsoring organisations. "Achieving a standard way of viewing data is going to be a very key component to transparency," says.

Marco Angheben, director at the European Securitisation Forum (ESF), an affiliate of the Securities Industry & Financial Markets Association, declares that the publication and format of data should be standardised so investors and interested parties are able to access and use information in a more efficient way. Indeed, the association and the securitisation industry are actively working on a number of initiatives to improve transparency in structured finance markets.

These include developing guidelines for consistent disclosure of methodologies to value portfolio holdings, regular reporting of post-issuance information and an industry standard set of definitions. As part of its aims, the ESF issued in December further specific market practice guidelines for European CDOs and it is planning to release similar recommendations for the UK non-conforming RMBS market.

"Security, collateral and loan level data is high on the agenda and we are working on disclosure by harmonising and creating consistency in specific fields and definitions. There is an ongoing standardisation effort for post-issuance reporting templates and formats for different asset classes," he says.

Angheben feels achieving transparency will be a lengthy process as there are various limitations, particularly at on loan- level data posed by data secrecy laws in continental Europe. It will also take some time for the adaptation of reporting systems.

The product manager believes that the industry is fast improving its own standards for disclosure in terms of completeness, accuracy and timeliness of report generation. Electronic distribution of reports in a standard format is under consideration, while investors say that more issuers are starting to release loan-level data and provide more confidence in the market. Issuer compliance with the ESF disclosure standards are published by Fitch Ratings under a five-star scoring basis along three major aspects of disclosure: collateral information, liability information, and accessibility information.

One nagging issue for investors is the requirement of investor reports provided by servicers, reporting agents or trustees to be password-protected, as they may contain confidential information, and to be accessible only by current or prospective investors and transaction parties. A number of issuers have already eliminated password-protected websites, thus making key transaction information more freely available to the public, though further improvement is required. "Limited access to information is still restricting the market and potential investors in CMBS transactions," says an analyst at an ABS evaluation company.

The product manager believes that investors need to have an accurate view on their portfolios and also be able to model as accurately as possible model the current structure as well as its evolution over time. Hence, transparency of structuring will become more critical as will the ability to stress the underlying collateral and look at the impact on cashflows under various assumptions. He believes that participants need to have structuring modelling and data transparency throughout their entire portfolio. "If not, they will not be able to come up with good valuations, projected cashflows, sensitivity and risk assessments, no matter how good their pricing model," he says.

The task of pricing and evaluating structured finance securities has become ever more imperative due to the market being void of liquidity and trades. In normal market conditions, counterparties can be a good source of valuation, says Danny Weigert, head of revaluation services at SuperDerivatives. But as conditions have worsened and affected the profit and loss of counterparties, they have been a much less effective way for of providing valuations in the last few months. "Providing evaluations for an illiquid product and hard to value derivatives is not something that can be generally be done in-house. Outsourcing to a third party is the only solution as the customer is looking for expertise in modelling and market data collection," he says.

Schemann-Teuber: crisis is about investor confidence

FEATURE: BACK OFFICE

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There is a lack of price points required for the evaluation of portfolios and the NAV of funds. Nonetheless, the evaluation analyst feels that the current market environment will help push forward aims to get clarity of how to treat and price illiquid and complex securities. "Market participants are looking to evaluation and how you value a security in an illiquid marketplace. They need timely pricing on structures and cannot now rely on just one or two sources but require multiple types of valuations," he says.

Financial accounting standards are also expected to further facilitate pricing transparency, in particular FAS157, requiring financial reporting of assets and liabilities to be categorised into three levels. Level one is unadjusted quoted market prices, for instance exchange or contract prices, while level two governs prices implied from observable market intelligence through correlation or statistical techniques, such as yield and rate curves. Level three relates to unobservable inputs to measure fair value and where there is no way to get independent market prices and use internal models or have assumptions on the pricing of those products. Level three pricing, says Principia's Long, has been responsible for the recent write-downs of positions and losses.

"There will be a real impetus for increased transparency for all products whether they are derivatives, structured finance assets or anything that is not exchanged traded or has a market observable price. Level three reporting is key as it means there is a lot of uncertainty and no way to validate this pricing. This will enable further analysis of financial balance sheets which will push many banks to put measures in place to improve liquidity in the market and reduce the number of level three products," he says.

The ESF is also considering future initiatives looking at guidelines for valuations, definitions and how to treat securitisation. "We are trying to harmonise what price assumptions are behind valuations to provide more colour to the pricing process," says Angheben at the. He believes that a new situation will arise in 2008 as for the first time in ESF 10 years the European ABS market is not forecast to grow.

"We are entering a phase where some of the current issues will be reconsidered, in particular the role of and how to improve transparency. There will be no single simple solution and various measures will be needed to improve disclosure and provide tools, which will take time," he says.

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From a macro-perspective, the fundamentals of the market have not changed and with assets sitting on banks' books and only a low number having been securitised, a backlog of huge supply is building up. "Clearly if investors are not intent on buying, it is certain banks will try and make transactions as transparent as possible to sell them successfully," says the evaluation analyst.

Principia's Long believes that the onset of a buyer's market and demand from the investor base for increased transparency and standardisation will push more players to make a firmer commitment to improving systems, compliance, standardisation and increasing the level of detail provided to the investor base. Previously, some participants may have felt they had no real obligation to provide more than just a brief summary of information rather than a comprehensive breakdown of all the individual constituents or items in a portfolio. "That thinking is very much out the window and they have no choice now. If they did not give that information they would not get the money from people investing in their products," he says.