

Securitisation – new due diligence challenges

The securitisation industry has taken major steps to improve transparency and due diligence. In this article we discuss some of the new challenges to restore investor confidence.



Transparency and due diligence – the new challenges

Most studies of the financial crisis and of the measures needed to restore investor confidence in the securitisation market indicate that enhanced disclosure of information and the ability of investors to analyse and understand risks in more detail are key issues.

The industry itself has taken major steps, the European Securitisation Forum (ESF) initiative on a standardised loan data template being one example. The Basel Committee and regulators have also responded to the G-20 conclusion that incentives for effective risk management of securitisations with new requirements on both originators and regulated investors which are now coming into effect. These in turn will place much greater focus on due diligence practices within the industry, which will affect most of those involved with securitisation and structured finance.

The measures are designed to improve transparency, ensure standardisation of information available to investors and to give investors the ability to undertake more sophisticated analysis of risk both before and after investing in structured finance entities. Investors will now be expected to perform some stress testing of the key factors effecting securitisation cashflows and the repayment of individual note tranches, which the new requirements on the publication of both loan level data and bond cashflow models will facilitate.

This added reliance on data is causing originators and sponsors to re-assess their own procedures for ensuring that data they put into the public domain is complete and accurate, both in relation to loan level data and the summarised asset pool information appearing in investor reports.



Banks which fund asset pools either themselves or via commercial paper (CP) conduits are increasingly insisting on accountants periodically checking that the asset performance and cashflow data they receive from the servicer is complete and accurate, and it is likely that lead managers on repeat issuing securitisation programme will want comfort on the accuracy of investor reporting as part of their own due diligence procedures. Experience in the US has also led to an increased focus on ensuring that loans have been originated in accordance with the stated policies and lending criteria.

Recent Changes

The G-20 stated “the Basel Committee and authorities should take forward work on improving incentives for risk management of securitisation, including considering due diligence and quantitative retention requirements by 2010”.

Since January 2011 there has been much change in the data and due diligence requirements for securitisation and in response to the statement above by the G-20, the Committee of European Banking Supervisors (CEBS) issued their much anticipated guidance on Article 122A of the EU Capital Requirement Directive (CRD), the Bank of England (BoE) has

This added reliance on data is causing originators and sponsors to re-assess their own procedures for ensuring that data they put into the public domain is complete and accurate, both in relation to loan level data and the summarised asset pool information appearing in investor reports.

issued final guidance on the rules for the Discount Window Facility (DWF) and the European Central Bank (ECB) has finalised its asset-backed securities (ABS) loan-level initiative. Each of these three sources of new rules will have a major impact on the level of information that is required to be produced on new and existing securitisations going forward.

Discount Window Facility

The DWF is a bilateral facility designed to be able to address short-term liquidity shocks without distorting banks' incentives for prudent liquidity management. At the BoE discretion eligible banks and building societies may borrow gilts, for 30 or 364 days, against a wide range of collateral in return for a fee, which will vary with the collateral used and the total size and maturity of borrowings.

The BoE set out its requirements for accepting Residential Mortgage-Backed Security (RMBS) and Covered Bonds into the DWF in its market notice of 30 November 2010. The implementation period for complying with these requirements is open and will end on 30 November 2011, although may be extended by one year at a penalty of greater haircuts for those not complying. The rules will apply to RMBS and Covered Bonds backed by collateral from non-UK jurisdictions as well as UK collateral.

The bank has provided details of a template for which the loan level data

must be reported and this must be provided on a quarterly basis. The Bank has adopted a 'comply or explain' basis whereby although expected to have the information the transactions will not be automatically rendered ineligible if the information is unavailable although additional haircuts may be applied.

A waterfall cash flow model will be required to be made available to investors, potential investors and certain other professional. These models must accurately represent how cash is applied through the waterfall. Full specifics are given in Annex B of the market notice. There is a choice of how to present the cash flow models but the calculations used by the cash flow model must be transparent to the user and the results must be capable of being recorded and retained by the user. The cash flow model requirement is unlikely to apply to covered bonds at the moment.

ABS Loan-Level Initiative

The ECB has finalised its ABS loan-level initiative which establishes specific loan-by-loan information requirements for ABS accepted as collateral in Eurosystem credit operations. It will increase transparency and make available more timely information on the underlying loans and their performance to market participants in a standardised format. In the past, assessments of ABS have been hampered by the lack of standardised, timely and accurate information on

single loan exposures. The Eurosystem believes that the new data requirements will help both investors and third-party assessment providers with their due diligence. Ultimately, more transparency will help to restore confidence in the securitisation market.

Article 122a

Article 122a of the CRD provides new requirements to be fulfilled by credit institutions when acting in a particular capacity, such as originator or sponsor, and also when investing in securitisations. These include retention on an on-going basis of a material net economic interest of not less than 5% (so called 'skin in the game'), due diligence and disclosure.

Article 122a mandates that certain disclosures are to be made available to the investor. The investor must then be able to demonstrate that they have 'a comprehensive and thorough understanding of their positions commensurate with the risk profile of their investments', and failure to do so will result in additional risk weights of up to 1250%, being applied to their investment.

The areas that the due diligence must cover include:

a) The structure, including the risk characteristics of:

- i) the securitisation position
- ii) the underlying exposures
- iii) structural features

b) The originator and sponsor; including, as applicable:

- i) the reputation and loss experience in earlier securitisations of the originators or sponsors in the relevant exposure classes underlying the securitisation position;
- ii) their due diligence on the securitised exposures and collateral



iii) valuation approach for collateral, including valuer independence

c) Additional considerations

Whilst all of these areas are in scope for both trading and non-trading books, the "intensity" of the review should be appropriate to these drivers.

Investors should also perform analysis that reflects the risk profile of the position it has taken, including concentration risk, impact on capital in stressed scenarios.

The guidance is also clear that due diligence is not a one off exercise, and should be reconsidered if there is a change in this risk profile.

Interrelationship

Some of the high level points required by article 122a, can most efficiently be met through compliance with the ECB or BoE detailed rules such as the loan level information and cash flow modelling. There are example datatapes provided by both the ECB and BoE that have resulted from working extensively with industry practitioners developing something which is achievable and moves towards the aim of transparency.

Loan Level Information

The loan level data tape required for covered bonds is the same as that for the discount window facility, although there are more mandatory fields. As the cash-flow model stresses prepayments, interest payments etc., there are

relevant fields on this data-tape which are not normally considered for the purposes of an issue. So we would do a gap analysis and discuss with clients extending our asset pool procedures on existing programmes in order to facilitate a smooth and efficient transfer to the new requirements. We would also perform some procedures to ensure that the data-tape we use for our asset pool procedures is the same as the loan level data-tape supplied to the Financial Services Authority (FSA) or the investors.



Cash-flow models

There is no standard template for the cash-flow model but the industry has started the move to standardise the development of these models, the key elements are that the models reflect the underlying mechanics of the structure and we are able to independently rebuild the models and verify back to the documents or to independently reperform calculations and compare our results.

How we can help

The PwC Structured Finance Group (SFG) offers a wide range of services to originators who are considering securitisation for the first time or are experienced repeat issuers. SFG provides independent advice and practical solutions using a multi-disciplined team of capital markets, corporate finance, accounting, tax, IT and industry experts who specialise in securitisations.

We perform asset pool due diligence and other transactional support work for a large percentage of the issuance from the UK and European programmes and have a number of year's experience which goes back to the very first European transactions.

Now that the guidelines have been issued for each of these various schemes we are able to perform walkthroughs and to look at the management information that is being produced alongside the transactional documents and provide guidance as to whether sufficient information is being produced and whether it is in line with that specified under the documentation. We are also able to offer insights into how the general market is responding to these developments through our involvement with the large volume of issuances.

Contacts

To discuss any of the issues raised in more detail, please speak to your usual PwC contact or one of our structured finance leadership team listed below:

Global & European



Peter Jeffrey

+44 (0)20 7212 5214

peter.c.jeffrey@uk.pwc.com

UK



James Hewer

+44 (0)20 7804 9605

james.hewer@uk.pwc.com

Australia



Colin Heath

+61 (2) 8266 1124

colin.heath@au.pwc.com

Americas



Frank Serravalli

+1 646 471 2669

frank.serravalli@us.pwc.com



David Lukach

+1 646 471 3150

david.m.lukach@us.pwc.com

www.pwc.com/banking

© 2011 PwC. All rights reserved. Not for further distribution without the permission of PwC. "PwC" refers to the network of member firms of PricewaterhouseCoopers International Limited (PwCIL), or, as the context requires, individual member firms of the PwC network. Each member firm is a separate legal entity and does not act as agent of PwCIL or any other member firm. PwCIL does not provide any services to clients. PwCIL is not responsible or liable for the acts or omissions of any of its member firms nor can it control the exercise of their professional judgment or bind them in any way. No member firm is responsible or liable for the acts or omissions of any other member firm nor can it control the exercise of another member firm's professional judgment or bind another member firm or PwCIL in any way.