

ABS Surveillance – Investors ignore the regulation at their peril

London 26 May 2015, by Simon Collingridge and Iain Barbour

Regulators require that Asset-Backed Securities ('ABS') investors conduct on-going surveillance with significant penalties for non-compliance. We investigate how regulators define surveillance requirements and how an investor can demonstrate compliance. This Market Insight introduces a surveillance framework enabling investors to demonstrate best practice to their regulator.

Introduction

Credit investment monitoring and surveillance is a priority for investors. It is not only good business practice but now a regulatory requirement with exacting penalties. The Joint Committee of European Supervisory Authorities' recent Report on Securitisation¹, in reviewing the nature and content of the due diligence and disclosure requirements, reiterated the importance placed by regulatory authorities on on-going surveillance. One of the key recommendations is that initial and on-going due diligence requirements should drive disclosure requirements recognising the varying needs of different types of investors.

So what is good business practice when it comes to the monitoring of securitisation investments and how does such practice translate into a framework that will satisfy a discerning regulator? The regulations are not prescriptive,

placing the onus on the demonstrability of the investor's business practice at the heart of its prudential guidance.

This Market Insight introduces Bishopsfield Capital Partners' ('BCP') recommended securitisation surveillance standards. We discuss why implementation of the BCP surveillance standards will not only inform sound investment decision-making, but also develop senior management confidence that the investor can demonstrate, against an objective benchmark, effective regulatory compliance.

What Regulations?

The securitisation market's primary focus, as it faces the new regulatory landscape, has been on the more stringent risk-capital requirements under the Capital Requirements Regulation ("CRR") and Solvency II. As these bedded down, focus moved to retention rules and the requirements for up-front investor due diligence.

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<http://www.eba.europa.eu/documents/10180/950548/JC+2015+022+-+Final+JC+Report+on+securitisation.pdf>
dated May 12 2015

Regulators have placed significant emphasis – certainly as regards the consequences of non-compliance – on the need to maintain “formal monitoring procedures” for on-going, timely surveillance and stress-testing of securitisation investments.

The CRR for Credit institutions and investment firms state the requirements for on-going surveillance and the penalties for non-compliance (See Figure 1)

Figure 1: EU Directive 575/2013

Article 406

1(g) Institutions shall regularly perform their own stress tests appropriate to their securitisation positions.

2. Institutions ... shall establish formal procedures...to monitor on an on-going basis and in a timely manner performance information on the exposures underlying their securitisation positions....

Article 407

Where an institution does not meet the requirements in Article...406 ... the competent authorities shall impose a proportionate additional risk weight of no less than 250% of the risk weight (capped at 1250%) ...The additional risk weight shall progressively increase with each subsequent infringement of the due diligence provisions.

The requirements under Solvency II for insurance and reinsurance companies are highlighted in Figure 2.

Figure 2: EC Solvency II Delegated Regulation 2015/35

256 (4)

Insurance or reinsurance undertakings investing in securitisations shall establish written monitoring procedures...to monitor performance of the underlying exposures on an on-going basis and in a timely manner.

257 (5)

Where insurance and reinsurance undertakings fail to comply with any requirements set out in 256 (4) to (7)... the supervisory authorities shall assess whether that failure shall be considered a significant deviation from the undertaking's system of governance as referred to in Article 37 (1) (c) of Directive 2009/138/EC (allowing supervisors to set a capital add-on)

The requirements included in the Alternative Investment Fund Managers Directive (AIFMD) are highlighted in Figure 3.

Figure 3: AIFMD Article 53 of Level 2

Where an AIFM has assumed material exposure to a material value of the credit risk of a securitisation on behalf of one or more AIFs it shall regularly perform stress tests appropriate to such securitisation positions...

AIFMS shall establish formal monitoring procedures ... in order to monitor on an on-going basis and in a timely manner performance information on the exposures underlying such securitisation positions. Such information shall include ... exposure types, percentage of loans more than 30, 60, 90 days past due, default rates...

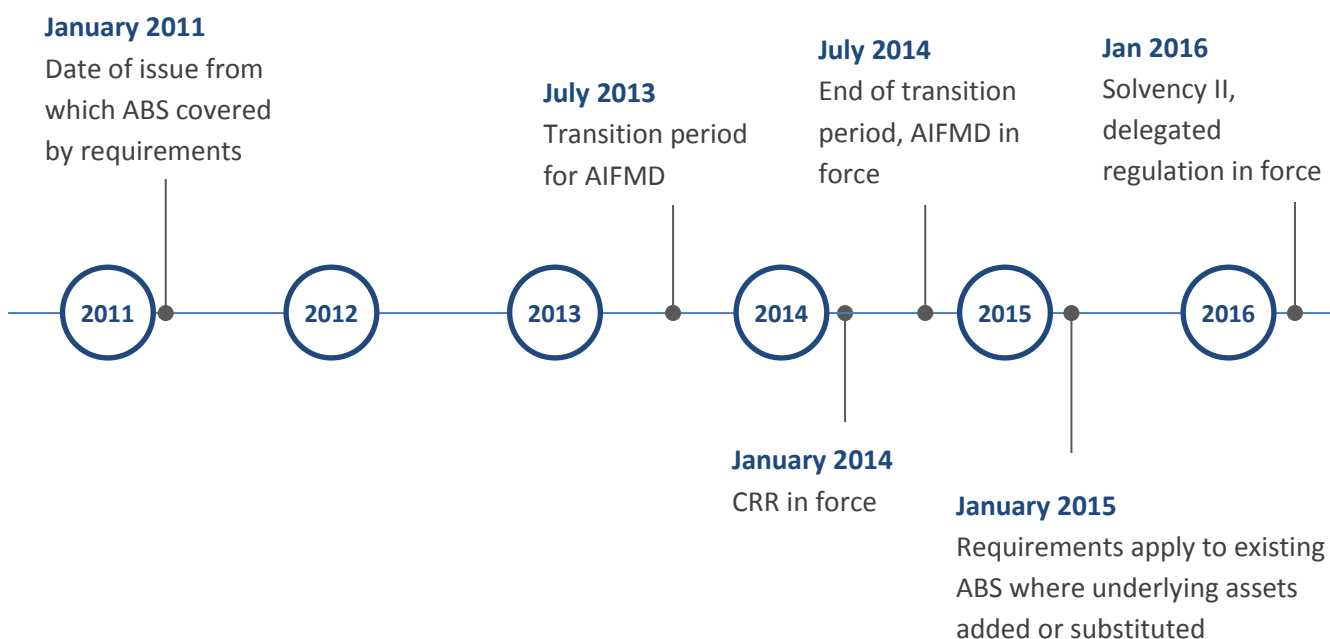
An AIFM must take “such corrective action as is in the best interest of the investors in the relevant AIF” where it finds that it has invested in a securitisation which does not meet the Art 17 Requirements”

All require that investors demonstrate that they maintain appropriate on-going surveillance with capital charge and other penalties for non-compliance consistent with those applicable to the more familiar retention and up-front due diligence requirements.

The regulations emphasise that investors must be satisfied that they can clearly demonstrate that their ‘formal monitoring procedures’ meet the regulators’ view of adequate and compliant standards of surveillance. The regulations are not explicit in articulating what they regard as adequate and compliant standards.

Compliance with these regulations cannot be put off. Figure 4 demonstrates that they are either presently in force or awaiting imminent introduction.

Figure 4: Implementation timeline



Regulators right to focus on Surveillance

At BCP, we support regulators’ emphasis on the critical importance of effective on-going surveillance of securitisation investments. Confidence that performance is being tracked and that risks are being identified and addressed early, at both an individual transaction and market sector level, is essential to the continued growth of a healthy and robust market.

One of the asset-class strengths is that it is able to be so closely surveilled. Ring-fenced portfolios of assets, immune from quixotic or subjective risk, supported by appropriate, transparent and consistent data can, with the right processes, be far more accurately monitored than many corporate or financial institutions bonds.

No excuses

Policy-makers have approached the critical issue of on-going surveillance of securitisations in a multi-faceted way, seeking to remove investor excuses through a step-by-step approach. To this end they:

- Ensured clear and largely consistent regulation across different investor groups;
- Introduced market reporting standards (initiated as central bank repo eligibility requirements); and
- Encouraged the establishment of data warehouses for enhanced data availability.

Although in its infancy, initial signs are that regulators are at least requiring corroboration that ‘boxes’ are truly ticked. Some regulators appear, anecdotally, to be requiring regulated institutions to demonstrate compliance even where the investment management is outsourced to a third party.

As regards enforcement, suffice to say that no prudent investor will want to see things go that far!

Seeing the wood from the trees

In their efforts to restore confidence in the European securitisation market, the authorities have emphasised the importance of

transparency, consistency and availability of relevant data. At the forefront of this effort have been the loan level data initiatives of the European Central Bank and Bank of England and great strides have been made by issuers to meet these requirements.

This is made more challenging by the lack of commoditisation in the securitisation market with differing practicalities and analytical value of asset data for RMBS, credit cards or CLOs.

However, the availability of data alone doesn't lead to more effective surveillance. Indeed a preponderance of data, unless properly used, risks complacency or unnecessarily burdensome and distracting operational constraints.

The efforts of the authorities to significantly improve the depth, transparency and consistency of data are to be applauded, but recent history clearly shows that data alone isn't enough. It is essential to maintain a clear framework and benchmarks against which the data will be reviewed, and procedures for the results to be analysed and employed for informed decision-making.

We agree that the increased depth and availability of data is healthy; if used properly, such data will serve to enhance investors' and the market's capacity to deeply understand risk in ABS portfolios and make informed decisions. Good judgement must not become swamped by unsustainable administrative burdens thus distracting from informed analysis.

Key guiding principles and a defined standard

While the policy-makers have placed on-going surveillance as a core pillar of their regulation of securitisation investments, there is limited clarity on the specifics of what such surveillance should look like.

We agree that investors should develop their own clear view on what is appropriate surveillance for themselves in the context of their appetite for risk. It is appropriate, in our opinion, that the onus is placed on the investor to demonstrate that their approach meets the necessary standards. So what are the necessary standards?

In developing BCP's approach, we are mindful that surveillance is not just about data analysis but demonstrating that the data is clearly understood and acted upon by competent and well informed analysts and decision-makers.

Our Standard is built upon certain key principles.

Key guiding principles

We advocate that all investors should:

- Develop and maintain policies that clearly document the investor's investment philosophy and risk appetite. The policies should govern not only initial investment decisions but also on-going portfolio management
- Document clear procedures for the surveillance and reporting of investment positions
- Establish minimum documentary standards for the availability of summary and granular, loan-level information
- Exercise appropriate and consistent governance over both investment decisions and on-going surveillance

Building from these core principles, BCP has developed its Surveillance Standard. We believe that if an investor implements this standard it will not only enhance its own risk management but also demonstrate a pro-active approach likely to be welcomed by regulators.

The BCP Securitisation Surveillance Standard

BCP Securitisation Surveillance Standard

BCP advocates that an investor should:

- I. Conduct periodic investment credit reviews that study not only historic information, but also establish key performance indicators (KPIs) and stress scenarios that act as early warning signals. These KPIs and scenarios should identify trends prompting the investor to initiate effective remedial action. These reviews should inform senior management 'big picture' analysis and thinking and examine systemic risks.
- II. Perform regular analysis and stress-testing of investments and the overall portfolio. Performance should be benchmarked against the KPIs informing management decision-making through clear signals. Management reporting should be regular and incorporate appropriate escalation of surveillance activities enabling analysts to highlight directional performance changes promoting timely action.
- III. Have documented procedures and triggers for the sourcing of loan-level data. BCP believes that loan-level data should be accessed and analysed as part of the periodic investment reviews and then, if specific KPIs are breached; such an exception-triggered surveillance escalation is core to an efficient, yet diligent surveillance framework.
- IV. Monitor counterparty and market risk (as relevant to an investment and the portfolio).
- V. Review information from independent credit information and analysis providers, including the credit rating agencies.
- VI. Maintain and regularly test the technology used to download and analyse loan-level data.
- VII. Document the right to receive the information required to perform on-going surveillance.
- VIII. Maintain the necessary human resources (at both a senior manager and analyst level) qualified and sufficiently knowledgeable to conduct the analysis.

There is clearly much detail beneath this framework and these standards. How they are implemented will be driven by each investor's own priorities, situation and experience.

Different strokes

There are a range of types of regulated institutions that are or are contemplating investing in ABS. Each may make different observations from this framework:

- **Investment managers** will likely be comfortable that their established surveillance processes, systems and teams meet regulatory requirements. Their clients may wish to understand whether they meet satisfactory standards. So how do you ensure that your

clients and indeed your own regulators can validate this? The BCP Standard offers an objective validation.

- **Investors** who have or intend to outsource their portfolio management to an investment manager will likely wish to understand whether relying on the chosen investment manager's service is sufficient for them to meet their own regulator's exacting standards. How do they validate this? The BCP Standard offers an objective assessment tool.

- **New Investors** looking to enter the securitisation market must consider the regulatory requirements for ongoing surveillance seriously. What are the necessary processes and requirements for each and every asset class and how should they be implemented? The BCP Standard offers an objective guide to their establishment.

The regulations should not discourage investors' participation; they should (and do) promote effective risk management and afford greater control. We believe that by implementing the BCP Standard, investors demonstrate both good business practice and address regulators' aspirations.

Timely consideration

The securitisation industry in Europe has responded proactively and diligently to the concerns of the regulatory authorities. Given the rightful importance that they have placed upon on-going surveillance, we believe that the time is now right for the market to demonstrate that it is ahead of this issue and for current investors and those considering entering the market to ensure that they have in place prudent and practical surveillance standards to

meet their own risk management needs and those of their regulators.

Should you wish to discuss this critical issue we would be delighted to share our thoughts on it. To do so please contact:

Simon Collingridge
(simon.collingridge@bishopsfieldcapital.com),

Iain Barbour
(iain.barbour@bishopsfieldcapital.com)

or any of our colleagues.

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