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Solid operations

Douglas Long, evp business strategy at Principia Partners, answers SCI's questions

Q: How and when did Principia Partners become involved in the structured finance market?
A: Principia Partners was established in 1995. The initial focus was on structured products more broadly, before structured finance as an asset class gained significant traction. Certainly before 2000 Principia concentrated on derivative products, enabling clients to structure, value, risk manage and account for these complex transactions.

That strong capital markets strength proved highly valuable as our focus moved towards structured finance and our client base developed. Now our clients include a wide range of banks, insurance companies, credit investment managers and other specialised shops; for example, Sallie Mae, EBRD, Genworth Financial, GE Capital, Channel Capital and Rabobank to name just a few.

We spent a number of years building up the structured finance capabilities of our portfolio and risk management solution, the Principia Structured Finance Platform (Principia SFP), introducing additional ABS/MBS functionality in around 2000. The fact that securitisations are dynamic, with constantly changing amortisation schedules and forecasting assumptions meant the product lent itself to tackling the challenges of understanding those products. It was a natural transition to become involved in the structured finance market and that is where we have been 100% focused ever since.

Q: So what has the product developed into? What can investors expect?
A: Principia SFP links all the operational aspects of managing and understanding a structured finance portfolio. It enables investors to manage their entire investment portfolio, alongside any associated derivatives and liabilities throughout its lifecycle. Portfolio managers use the system to support initial investment decisions, as well as proactively monitoring and adjusting their existing portfolio of investments.

The system supports the full deal structure of a transaction, including all the associated issuance and performance metrics. This can then be analysed in the context of the portfolio and its operating guidelines over time.

Being able to drill down to the tranche, collateral performance or credit enhancement level for any security you have data for is one advantage. It also gives you a world view to structure, view and manage your hedging positions and liabilities, and assess your ability to fund purchases of additional securities.

The idea is to achieve a complete view of a structured finance investment business, creating a backbone between the information provided from third parties and trustees in all its forms, and the ABS portfolio. You can consistently bring all the elements together to carry out sophisticated risk management and surveillance and have the transparency to process and disseminate risk information for any stratification of the business.

Along with this, it gives you the operational control to perform timely reporting, maintain compliance and flow all your positions through to accounting. Such a platform is particularly relevant now, given the increasing regulatory demands and the need to disclose valuation and performance assumptions for compliance monitoring and accounting treatments. Having all the information and data in one place allows end-users to more efficiently stress test asset or portfolio performance and better demonstrate the use of robust valuation techniques.

To proactively address the market demands since the crisis we accelerated our release cycle to every six months. For example, we launched a standard feed to bring in and normalise issuance and performance data from multiple sources in our last release and we are now working on bespoke integration with some of the leading performance data providers. Our goal is to continue to deliver the most comprehensive and standardised infrastructure for the operational management of ABS, MBS and CDO securities – right of out of the box.

Q: How do you differentiate yourself from your competitors?
A: We identified a niche and dedicated our development efforts to the unique requirements of the structured finance investor base. The emphasis at present is on being able to consolidate all the analytics and data required to manage multi-asset class portfolios.

Organisations often use multiple sources of data for the performance information of the transactions they hold – different asset classes or geographies often have different specialist data providers. We provide the functionality to consolidate that universe of information and model past, actual or future performance off the back of it and then use that for investment analysis, risk oversight, compliance and accounting.

The main opposition comes from the development of internal databases and spreadsheet-based systems. We have seen that in the new environment a piecemeal approach to consolidating and managing these portfolios makes it very difficult to satisfy all the internal compliance and regulatory pressures being placed on organisations.

The challenge is to understand credit and asset exposure on a bond-by-bond level first, but then on a portfolio level as well. Trying to link this understanding to the delivery of mark-to-market and compliance reporting can be inefficient using disparate ancillary systems. Trying to track all the dynamic cashflows for multiple asset types together or forecasting future cashflows can be an operational burden unless monitored in a single, controlled software environment.

Q: Which challenges/opportunities does the current environment bring to your business and how do you intend to manage them?
A: During the peak, demand for the Principia platform was driven by the need to demonstrate conservative operations, strong risk surveillance and very specific reporting capabilities – so for us really the opportunity is very similar now. In fact it is greater than ever because today anyone managing structured finance assets must focus on exactly these core competencies.

The main shift has been who derives value from the solution. Prior to the crisis, rated operations – such as SIVs, conduits, bond funds and CDPCs – benefited from our software.

These were small shops, run like mini-banks. They needed to manage large portfolios with a limited number of staff while proving to rating agencies and investors that they had robust operations in place to understand these portfolios through to maturity.

Although only a small proportion of our total client base, we were the predominant provider of software to them because of the operational capabilities of the platform and our understanding of the compliance issues that needed to be addressed. Now, the opportunity is huge because anyone managing or investing in structured finance assets is being mandated to have this same level of operational control, due diligence and transparency.

As assets have come on balance sheet, the value of having data, portfolio management and risk surveillance systems dedicated to ABS and MBS is something we hear about on a daily basis. Where financial institutions often managed these assets on existing treasury platforms or spreadsheets, they now have to get to grips with the nuances and moving parts of these securities. They can't be treated like a straight bond anymore just because they are highly rated.

Some larger banks and investment managers did build strong internal capabilities in this area, so the challenge initially was to break into the broader market, which we began to do in 2006-2007.

We are exposed to the same challenges facing our clients and we work diligently to understand the impact of the upcoming tsunami of regulation. This is also an opportunity for us though – we have spent three years developing and delivering software that can help satisfy the conditions and specific risk management techniques that authorities and regulators are now demanding.

Q: What major developments do you need/expect from the market in the future?
A: The Basel Committee has layered on a qualitative measure for capital charges associated with structured finance exposures: financial institutions won't qualify for capital relief unless the investor can demonstrate that there are strong operations in place. We will see this becoming a reality over the next year; as the CRD is implemented in the EU for example. A paradigm shift occurred during the crisis and this focus is not surprising – robust operations and risk surveillance are now a necessary part of running a business.

There are many challenges around justifying investment decisions and lots of data to analyse. It's extremely operationally-intensive: in the time it would take our system to do the work, you may have only covered 10% of the detail by doing it manually. This isn't seen as a viable way to run a structured credit portfolio, from an internal and now an external perspective.

Looking ahead, the biggest challenges for the structured finance market are related to translating regulatory requirements and market demands into practise. We still have a long way to go.

There needs to be more clarity about the impact of converging regulatory policy and how rules work in unison to stimulate issuance and restore investor confidence. This will help the secondary market to stabilise further; that way, more long-term investors will return.

There are signs that the new issue market is coming back, stimulated by some return to normality in lending activity and the provision of consumer credit. This, in combination with more transparency, disclosure and simpler structures, will provide a foundation for the future. The interesting thing to see now will be how investors prepare themselves to participate in this new world.

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