The impact of the sovereign debt crisis on structured finance valuations

The European sovereign debt crisis is continuing to heavily impact the financial markets, the structured finance sector included. In this chapter, Interactive Data's director of EMEA valuations, **Anthony Belcher**, examines the impact of the crisis on the pricing and valuation of structured finance bonds, the practicalities of pricing securities in the event of a sovereign default or currency re-denomination, and the benefits of an evaluated pricing approach in times of economic uncertainty

The European structured finance market began on a positive footing last year: optimistic performance figures released in the first two quarters of the year contributed to the already-tightening spread environment, liquidity was good and issuers long-absent from the primary market were contemplating the sale of new structured finance bonds.

However, as Q2 moved into Q3 and the seriousness of the issues of sovereign debt intensified, wider market concerns started to take their toll on the structured finance sector. Spreads started to reverse their tightening trend, liquidity dried up and issuers dropped plans to issue bonds.

The ordinarily-robust covered bond sector also started to show signs that it, too, may be affected by sovereign issues. Having performed well compared to the ABS sector over the past three years in terms of issuance and ratings, concerns emerged that the banks providing the covered bond guarantee could see their credit worthiness impacted or their ratings cut, should they have large exposures to peripheral sovereign debt.

Spread widening has affected structured finance assets across the whole of Europe – not just those where the sovereign debt issues are most prevalent, such as Greece or Spain. However, a closer look at the structured finance securities originating in these jurisdictions shows a significant level of widening for deals in line with sovereign debt in these markets, versus the asset-backed markets of northern Europe.

So far, however, spread widening and diminished liquidity in structured finance bonds – Greece's and Spain's included – have been based on expectations of weakening collateral performance rather than on solid figures (at the time of writing, Q3 performance figures are yet to be confirmed).

Indeed, there remains an element of uncertainty regarding the impact of austerity measures on the performance and pricing of structured finance bonds from peripheral sovereigns such as Portugal, Greece and Spain. Greece, for example, is expected to cut the jobs of 50,000 state workers as part of its austerity package. While this may be expected to impact mortgage payments and thus the performance of the RMBS referencing those mortgages, the effects could be lessened based on the demographics of the affected state workers. Similarly, Spanish unemployment is increasing from an already high level. In this case, the majority of unemployed citizens fall within the youth

category, and this demographic dispersion could limit the impact on the Spanish mortgage and RMBS market.

Market participants may take note of the Irish structured finance market when attempting to understand the impact of austerity measures on structured finance bonds in the months ahead. This sector would appear to have become an exception to the rule, in that austerity measures have been put in place ahead of the other peripheral nations. Those measures have already been priced into various Irish structured finance deals and price volatility has lessened as a result.

Overall, as 2011 drew to a close, market participants were resigning themselves to the view that positive performance within the structured finance sector witnessed in the first two quarters of the year could be attributed to overly-optimistic assumptions for the economy through 2011 and 2012. The recent downbeat OECD growth forecasts will continue to weigh upon the market into 2012.

It also remains to be seen whether the spread widening in the broader European structured finance market in the latter part of 2011? can be linked purely to the Eurozone sovereign debt crisis, or whether the ongoing recession-like profiles that are being seen in jurisdictions such as the UK are also responsible. Whatever the reason, expectations are now being reset, which should have some bearing on the pricing of structured bonds going forward.

It is important to note that the scale of the spread widening in late 2011 was not as severe as the widening witnessed in 2008 and 2009: the market has been able to put into action vital lessons learnt over the course of the past three years. The sweeping downgrades and fire sales of structured finance bonds seen in 2008 and 2009 have not materialised in the current crisis. Similarly, while liquidity has deteriorated, a two-sided market still exists. Trading flow has dropped, but to a level where the markets are still operating rather than being completely frozen.

Contrary to initial market expectations, structured finance deals have, for the majority, performed as intended, with those investors that sold off holdings in haste three years ago having realised losses.

There have, of course, been numerous sovereign downgrades over the past year; however, the market usually anticipates and reflects these declines in credit quality in advance. As a result, there has generally not been a significant impact on pricing following such downgrades.

Default Scenarios

The likelihood of sovereign default and re-denomination risk became increasingly topical amongst global investors throughout last year, particularly following Greece's controversial response to the Eurozone rescue plan in early November. At the time of this writing, that has still to be resolved and other sovereigns are becoming increasingly engulfed in the crisis.

On a fundamental level, should a sovereign default, Interactive Data's evaluated pricing methodology for such securities would not change dramatically, although the underlying reference data would need to be updated. In such a scenario, it would be a question of understanding what needs to be changed with respect to the par amounts on bonds, and what is happening to the coupon amounts.

In terms of rating downgrades, Interactive Data's systems would automatically update, although as discussed previously, the market will have already priced in downgrades or defaults for many securities before they are officially announced. Another question at the time of a default would be concentrated on recovery rates and how they would ultimately pay back.

An actual split of the Eurozone and the re-denomination of collateral and contracts would be an event of much larger magnitude than a sovereign default. While current market opinion does not gauge re-denomination as a significant probability, the market believes there is a far greater chance of it happening now than there was a year ago.

In a re-denomination scenario, the challenge for our evaluated pricing systems would come in the form of understanding which securities and which agreements would move to different currencies. If debt is denominated in Euros, would it remain in Euros or move to a new currency? This is where the main source of valuation uncertainty lies: determining if the impact of currency re-denomination on the pricing of specific securities will be correlated with what happens to the denomination of the outstanding debt.

Many financial analysts have speculated on the impact of a Eurozone split and the ensuing impact of currency re-denomination on the financial markets. Some suggest that if a country such as Greece left the Euro, the impact on related ABS would be significant, with downgrades at the senior level and large losses on the more junior tranches.

Interactive Data's systems are able to cope with multiple currencies. If debt were to be changed into multiple currencies, Interactive Data would, in effect, reverse the process that was put in place when the Euro was founded. Interactive Data also has the capacity within its systems to add additional currency codes. What is more important is that the evaluation professionals are able to continue reviewing and reflecting the market in the face of what would be significant market volatility. The evaluation approach used by Interactive Data is particularly well-suited to this, allowing evaluators to speak to market participants and base evaluations on various types of market data, something that not all valuation approaches can accommodate.

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It is critical in times of economic crisis, such as in the aftermath of the Lehman bankruptcy, to keep lines of communication with clients open to help cope with stress in the market place. Significant lessons have been learnt from the aftermath of Lehman's default. One of the most significant issues is understanding the current situation by talking to market participants, and feeding that data into relevant systems. Interactive Data has prepared for this by increasing the number of our sources and contacts within the market.

An evaluated pricing approach

Interactive Data's approach to evaluated pricing is market-based.

One of the biggest challenges facing industry players is maintaining contact with the market and being able to obtain transparency to pricing information. While this process can be time consuming, it provides the ability to view an evaluation alongside contextual information. The benefit of an evaluated pricing approach over a 'black box' or composite valuation approach is the ability to understand the nuances in the markets that are reflected in the opinion of value. Due to the nature of OTC markets, it is impossible to see all quotes and trades, therefore it is important to fully understand the information that is available so that it can be contextualised and applied to similar transactions for which information is not available.

In practice, for many of the deals in the structured space, there may be plenty of trading information data for one or two tranches within a deal, but very little on other tranches. It is important to be able to analyse the information on the liquid part of the deal and model collateral performance assumptions based on this to value other tranches within the deal. Interactive Data's evaluated approach means that clients can see the underlying assumptions that are used, and the evaluated pricing methodology behind that evaluation.

Similarly, should a dealer quote a price on a specific tranche of an ABS one day and a completely different price the next, it is important to understand why that price has changed – a black box model would find it difficult to incorporate such context. In times of volatility and high divergence of opinion on bond pricing, an evaluated approach permits the incorporation of deeper analysis and understanding of the assumptions in the market, as opposed to a model-based algorithm.

Interactive Data collects ABS market data from a variety of buy-side and sell-side sources including investors, traders and brokers that are active within the structured finance market. A large proportion of the firm's clients are on the buy-side, with around 94% of the top global asset managers counted among Interactive Data's user-base. An increasing number of sell-side institutions also subscribe to our services, reflecting the increasing demand for independent valuations. The rise in the number of independent price verification (IPV) functions within banks illustrates this.

When collecting data points for evaluations, Interactive Data has daily or even hourly runs, depending on the security. These points of reference are factored into Interactive Data's end-of-day evaluations, which are designed to reflect levels at the close of the European markets.

The Interactive Data Challenge Portal

Since 2010, Interactive Data has offered clients' access to its Evaluated Pricing Challenge Portal – an online tool that allows clients to submit, track and create reports for evaluation challenges. At the same time, the portal gives evaluators the opportunity to enter into a dialogue with clients. For example, in the structured finance space, Interactive Data's evaluators can discuss assumptions such as the weighted average life (WAL) of an instrument, the market colour that the evaluator has seen and how that information is reflected in evaluations. In this way, the context of an evaluation can be explained to clients, something that is impossible with a black box approach.

The service also provides audit trails and compliance reports for a firm's pricing challenge process. This means that Interactive Data's clients are able to keep track of that aspect of the workflow and have enhanced oversight of the challenges they have raised and what the responses have been on an aggregate basis. Clients are therefore at an advantage should they need to present data to auditors or compliance managers. The portal itself has a function that lets the client run standard reports.

At any point in the day, clients are given the option to enter one or multiple evaluated pricing challenges directly through the portal, track existing challenges and monitor progress through the use of various report generation options, without having to contact Interactive Data's client service team.

Client challenges are categorised into several levels based on the amount and type of information provided, with those challenges that include market information prioritised for review. Clients receive

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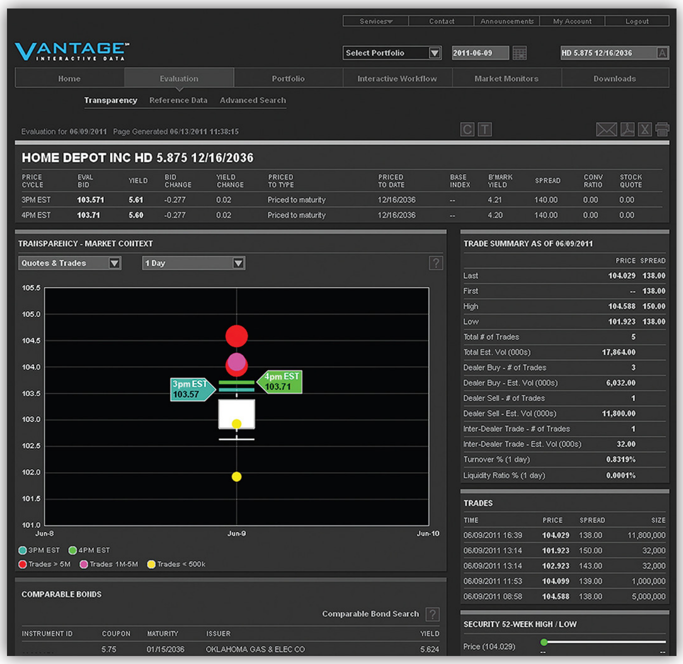
instantaneous feedback on the challenge level and the expected turnaround times based on the level of information provided.

Transparency/Vantage

In a post-Lehman world, transparency is key to market participants in order to explain how they arrived at a valuation point and which assumptions were used. The need to obtain as much information and colour as possible surrounding pricing points is essential and is being driven by not just by regulators, but by auditors, internal compliance officers and investors themselves.

One of the main requests Interactive Data currently receives revolves around the ability to provide context: how and why an evaluator has arrived at a particular evaluation; what was the market colour collected and utilised; the depth which an evaluator is seeing in certain aspects of the market; and what assumptions were used.



Interactive Data has responded to this call for further transparency by introducing a new web-based application called VantageSM. This portal gives clients the ability to understand and visualise evaluated prices within the context of proprietary trading information, market colour and assumptions in an intuitive and efficient manner.

Conclusion

Lehman's bankruptcy has not only taught the market vital lessons that have been applied in the current economic crisis, but it has also meant that valuation systems are better prepared to deal with a wide range of scenarios, including a potential sovereign default or currency re-denomination.

While Interactive Data's underlying methodology has not changed in the wake of the global financial crises of 2008 and 2009, the number of resources it employs has increased, systems have been updated and the firm has invested heavily in infrastructure. That investment has paid dividends as the sovereign debt crisis of the past few months has progressed, with further investment planned for these areas.

While the structured finance market has completed another turbulent year, it has – overall – stood its ground throughout the sovereign debt crisis, in spite of wider spreads and diminished liquidity. However, its future will be determined by the outcomes of the Eurozone crisis talks. If the solutions that are eventually put forward are deemed to be acceptable in the wider markets – thereby giving a surer footing from which the economies can work – then there is every chance of a return to tightening ABS spreads and renewed interest in primary issuance.

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