Portfolio progress

The trend of banks rationalising their business models continues apace across Europe. **Corinne Smith** explores the role of securitisation in their portfolio optimisation efforts.

The need for banks to fundamentally rethink their business models emerged post-financial crisis and continues still across Europe. Beyond disposals of non-performing assets, this entails focusing on core strategies and markets, while reducing exposure to or exiting others. Securitisation plays a crucial role in helping banks achieve these goals – whether that be via significant risk transfer transactions, NPL ABS, portfolio acquisitions or new lending activity.

"Across Europe, banks are rationalising their businesses and refocusing on core competencies, which provides us with opportunities to acquire unloved portfolios," confirms Hubert Tissier de Mallerais, partner and senior portfolio manager at Chenavari Investment Managers. "Such activity has remained a theme over the last 12 years, with the realisation that capital is a scarce resource and needs to be managed properly. In turn, this has given rise to portfolio optimisation; in other words, reallocating capital from non-core areas of the business to those that are deemed to be core areas."

Portfolio optimisation can be broken down into calculating the breakeven price of keeping certain assets on-balance sheet – taking into account the associated capital consumption and provisioning – versus selling out of those positions, according to Gianluca Savelli, co-founder

Hubert Tissier de Mallerais, Chenavari Investment Managers

and ceo of NPL Markets. "Selling a portfolio is only the final part of the process – the first steps are deciding the optimal portfolio composition, the correct parameters in which to reduce exposure to certain sectors and how to deploy the freed-up capital. Another question to answer is which expenses should be budgeted for in the sale process," he states.

Usually, this is a chief risk officer/board-level strategic decision, in terms of whether a bank wants to remain in certain asset classes and jurisdictions. Savelli claims that platforms like NPL Markets can aid in this analysis by defining a bank's current position, plus the risk factors it identifies as drivers of the decision. A user can decide which parameters – default rates, interest rates and so on – to stress and the platform will then calculate the optimal portfolio in terms of risk/reward and value at risk.

John Pellew, principal, distribution and securitisation at Arrow Global, notes that there are two sides to portfolio optimisation: portfolio construction – in other words, buying and servicing assets – and squeezing the most juice out of those assets. The foundation for both sides is data.

Generally, data is structured in a rigid, static XML framework, making it challenging to update the relationship between datasets. "Ideally, there should be a three-dimensional view of data, where the relational hierarchy is neural-linked and therefore more flexible," Pellew observes. "This provides opportunities to run more sophisticated algorithms and AI tools to create better insights into the performance of the assets and therefore the potential to extract greater value. Ultimately, this enables an organisation to optimise their portfolio management."

According to Pellew, such an approach requires a team with four skill-sets: data scientists, data architects, data engineers (to create appropriate analytics and extract the data) and a business subject matter expert to interrogate and interpret the patterns within the data.

Chenavari's European loan portfolio private credit strategy invests in consumer, mortgage, SME and corporate assets across the SRT, portfolio acquisition and new lending segments. "The SRT market is typically easier to access than the portfolio acquisition and new lending spaces because the issuers are banks and buy-side participants can theoretically become involved in the flow. As such, there are periods when the SRT market becomes expensive, as well as periods of 'feast or famine' on the supply side. This is why we like the flexibility of not having to chase deals and being able to deploy capital selectively in different ways," explains Tissier de Mallerais.

Gianluca Savelli, NPL Markets

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The portfolio acquisition strategy has a different construct in terms of risk/reward and the relationship with the counterparty. With SRT, the investor is seeking the best possible alignment of interest with the issuer – the aim is to truly share the risk. With a portfolio acquisition, the bank wants to exit the position.

"The bank provides representations and warranties on the portfolio, but otherwise it's caveat emptor. Our approach is different as a result – we undertake the same due diligence, but there is limited reliance on the seller. It means that the deal can be riskier, so it is priced differently and hopefully offers greater upside potential via refinancing and eventually selling the assets," says Tissier de Mallerais.

He continues: "The carry component in a portfolio acquisition is less important than the upside from exiting the position in the whole loan or securitisation market. Overall, the return we're able to achieve in acquisitions and new lending is often higher than in SRT, which is a buy-and-hold carry investment."

John Pellew, Arrow Global

Opportunities in the new lending space, meanwhile, are being driven by evolving consumer habits and the emergence of non-bank lenders and fintechs, whose need for funding has increased following the withdrawal of banks from the segment. "Non-bank lenders don't have the same access to capital as banks, so we can provide this capital. We seek alignment with the lender, but they tend to be thinly capitalised, which needs to be taken into account," Tissier de Mallerais observes.

He adds: "The purpose of the deal is to help a business fund its assets and we view ourselves as a capital partner in this context – whether that is as a senior or a mezzanine lender, or via a forward flow or a warehouse agreement. The level of risk we assume and the requirements of the counterparty vary, but the challenge is to ensure the capital is deployed in the most attractive way."

The originators are usually backed by private equity or venture capital firms, which perceive Chenavari as a good partner. As Tissier de Mallerais explains: "We speak the same language, given that we are levered investors and understand the whole loan and securitisation markets, albeit with differing return targets. Sourcing opportunities in this space requires familiarity with the fintech ecosystem and being viewed as a good partner, in terms of financing the assets and taking them to the capital markets."

Barriers to entry across the new lending, portfolio acquisition, SRT and NPL ABS segments remain high. However, the latter has the potential to become more mainstream once there is greater availability of and trust in data.

"Once the data gap is bridged between buyer and seller, it follows that the bid/ask gap narrows and smaller investors can enter the market. Once the asset class becomes less specialised, liquidity increases and price discovery improves," Pellew argues.

He reports that over a 12-month period, Arrow Global's collection forecast accuracy levels are within plus or minus 1%. "With these kind of accuracy levels, the NPL market becomes less scary. NPLs are seen as a high-risk product because the assets are distressed; therefore, providing transparency around data and performance is key to the market perceiving the assets as a more manageable risk."

One way in which Arrow Global is seeking to optimise the capital efficiency of its asset base is to structure more bespoke products that provide a better outcome for both buyer and seller. The aim is to apply a big programme mentality – like that seen in the US mortgage market – to securitisation by using blockchain technology to slice assets into any number of permutations.

"Once assets are digitised, buyers can build investment products based on their own requirements, with post-trade transparency provided by appropriate data and analytics. We can demand a premium for this service, which helps Arrow optimise its value proposition," says Pellew.

He adds: "In this way, the market can move from a sell-side driven cycle, where the buyer chooses from the stock on a shelf, to a demand-driven model that is more bespoke and therefore of greater utility for the buyer and greater value for the seller. This, in turn, allows the seller to optimise the origination process – whereby assets are originated based on demand for the product."

Looking ahead, there does not appear to be an end in sight for portfolio optimisation activity. "Banks are constantly having to reallocate capital. CRD 4 means that they are typically three times less levered than they were in 2004 and they're compensating for this by focusing on their competitive edge and cross-selling opportunities, as well as by reducing exposure to credit losses and reputation/regulatory risk," Tissier de Mallerais concludes.

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