EXPERT Q&A

From self-sourcing to bank partnerships and synthetic risk transfers, private credit origination models vary widely, with implications for the underlying investor, says Arrow Global's Toni McDermott

Evaluating private credit origination models

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Q How do origination models vary across private credit?

Origination models in private credit vary depending on the specific sector and set-up of the asset manager. Direct lending funds, which compete with bank-leveraged finance, typically operate with a centralised origination function, mirroring the bank sponsor coverage model. Similarly, the origination function for real estate private credit is normally centralised for larger-ticket lending, like the bank commercial real estate warehouse and the commercial mortgage-backed security model it has largely replaced.

Private credit has also expanded into more granular asset-backed lending, including consumer and auto finance, as well as infrastructure and esoteric specialty asset finance, which banks had previously originated, warehoused and then securitised. The origination model here is often a forward flow partnership – or offtake agreement – with both bank and non-bank originators alike, which is necessary because of the granularity and operational intensity of these sectors.

Arrow's origination model is decentralised, reflecting our strategic focus on more granular, operationally intensive residential real estate-backed opportunities, where local relationships and expertise matter. We have built our own local operational capabilities over the past 20 years in eight Western European countries, with a workforce now of over 4,000 employees on the ground.

We have positioned ourselves to operate successfully in the highly fragmented European residential real estate market where the majority of our origination is off-market and where we believe the risk-return profile is most attractive.

To summarise, direct lending firms can centralise their teams in financial hubs such as London or New York and allocate capital from there, covering larger-ticket deals that may require only 10 or so transactions per year. In contrast, firms that are focused on more granular private credit transactions with higher operational complexity need either to have networks of local partners to help originate and manage risk, or to be vertically integrated and own these in-house.

Q How exactly does the origination model impinge on alignment of interest?

When firms originate via non-exclusive local partners, it is crucial to understand any potential selection bias and to agree and document in advance how investments will be managed post-transaction.

The alignment of interests and risk-sharing between independent operators has to be contractually enshrined in detail, for example by defined partnerships for specific asset types or risk profile for specific time-periods and performance-based fee structures. Maintaining this alignment requires supervision and time to develop the requisite trust and an efficient operational cadence between separate organisations.

At Arrow, we operate as a single, vertically integrated firm, exclusively sourcing investments for our funds. This means that everyone, including our local platforms, benefits when our investments perform well and vice versa. This model is not easy to establish. It requires significant time and capital, but the resulting efficient operational cadence and alignment of interests that comes from being all one firm is worth it.

Q Where does synthetic risk fit in as an origination strategy?

Synthetic risk transfer (SRT) allows investors to assume the risk associated with loan portfolios (which are normally granular and difficult to transfer like SME loans) without purchasing the loans outright or having to manage them. Instead of selling loans in their entirety, the lender effectively transfers parts of the credit risk, buying excess of loss insurance above pre-agreed levels. European banks, and increasingly US banks, use this strategy extensively to free up regulatory capital and as such, insurance, when suitably structured, can be recognised as an effective risk mitigant under bank capital rules.

> *"Firms focused on more granular private credit transactions... need either to have networks of local partners to help originate and manage risk or to be vertically integrated and own these in-house"*

On the buyside, SRT is a way of getting tailored access to granular, diversified asset-backed exposure without requiring any operational capability to manage it. Successful execution relies on forming a strong partnership with a bank, conducting thorough due diligence to develop a deep understanding of the bank's origination and servicing model, any potential selection bias and expected performance, as well as the structural aspects of the contract to box out the loss protection provided.

We have not focused on SRT at Arrow since our model is all about the value add that our own operational capability can bring to bear for our investors.

Q Do origination models need to adapt to economic cycles?

Yes, is the short answer. We have set ourselves up to be an all-weather investor, with strong local expertise in real estate equity, lending and credit – all asset-backed, primarily by residential real estate. Our focus on the European living sector is supported by the long-term structural trends of strong demand and limited new supply, particularly in growing metropolitan areas where urbanisation is fuelling demand for additional housing.

Q What role is technology, and artificial intelligence in particular, playing in private credit origination?

This is becoming increasingly important across the industry. In our case, we are a data-rich company, having specialised in granular assets over 20 years. We are at the forefront of leveraging this data through artificial intelligence to best target our servicing efforts for the assets we manage.

We also use AI in sourcing and diligencing potential investments. For example, in some of our opportunistic strategies, we use it to rapidly analyse and search through large volumes of public information and documentation to identify which opportunities meet our criteria to pursue and diligence (and which to avoid) with much greater accuracy and efficiency.

The cultural and regulatory implications of AI adoption are a key industry focus as firms navigate how best to integrate these technologies while maintaining security and compliance. ■

Toni McDermott is the chief investment officer of Arrow Global's Credit and Lending group