The Investment Podcast

Episode 37: The long-term megatrend of European private asset-backed finance
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Speaker 2: This podcast is for investment professionals only.

Romil Patel: Hello, and welcome to *The Investment Podcast*. My name is Romil Patel, and I'm delighted to be joined by James King, Head of Structured Credit, and Jo Tomkins, Investment Specialist in the Structured Credit Team for yet another episode. James, Jo, welcome back.

James King: Hi there.

Jo Tomkins: Hi there.

Romil: Last time we considered the global financial crisis and its aftermath, where it was recognised that European banks had simply gotten too big. Indeed, as a percentage of a nation's GDP, some of these banks' balance sheets were in excess of 100%. In the context of ever-growing regulatory capital requirements following the financial crash and historically lower profitability, banks have utilised several tools to optimise their balance sheets and reduce the capital they're required to hold against their lending activities.

As banking regulation and deleveraging remains in focus, what does this imply for the investment opportunity set across the private and structured credit space – and how is this opening up possibilities for investors to connect with these key themes?

Jo: Right now, there's a lot of reasons to be excited about our asset class. You've mentioned bank deleveraging and regulation already. A lot has been made of the growth of private financing opportunities, particularly in Europe. These themes are very much still in play and are the driving force of many of the opportunities we're seeing in the markets. What we're seeing is an abundance of high-quality opportunities in significant risk transfer [SRT] and specialty finance, for example. On one hand, increasing capital requirements have led to growing use of credit risk securitisations like significant risk transfer as a way for banks to essentially achieve capital relief on certain areas of lending.

For similar reasons, also, we're seeing regulatory pressures motivating some banks to offload core portfolios of legacy loan assets from their balance sheets. This is particularly because lenders might be looking for risk headroom for particularly capital-intensive assets or in scenarios where they're looking to exit certain lending verticals that are deemed no longer core to them. We really like these two areas, what's driving the asset opportunities is very much structural in nature.

We'd also highlight that the investment opportunity set is not just limited to banks. We've also seen a growth in non-bank originators in Europe. That's been very much a by-product of banks retrenching and pulling back from capital-intensive areas of lending in consumer and both corporate lending. While the specialist non-bank lending market is not as advanced as it is in the US, I think James would no doubt agree with me here that this is leading some pretty interesting asset-backed financing opportunities for patient and stable capital providers, particularly in the areas of consumer lending.

James: Yes, absolutely. I guess what we're generally seeing is that in areas such as consumer finance and lending to small and medium enterprises, very often banks are finding that the capital charges associated with essentially lending the sort of full capital structure to those areas is inefficient from a capital perspective. What they're increasingly looking to do is take a more senior position in that lending, and that's creating mezzanine and in some cases equity financing opportunities for a whole host of lending pools.

This has essentially created a number of gaps for private investors to take advantage of. We've seen this in situations such as pools of auto loans, pools of residential mortgages, whereby banks are looking to perhaps provide senior finance to those pools, but that creates an opportunity for private credit investors to invest at the mezzanine level. Because there's limited competition for these types of assets, there's not that many players in Europe, the returns can be very attractive.

Romil: James, how does this differ to the US and is there a model there that shows attractive opportunities that we could step into here in the European space?

James: I think it's really a question of how much more developed the US market is and how many more players there are within private credit in the US. If you think about the US banking sector, in terms of percentage of GDP, the balance sheets are much smaller. Bank finance is a much less important part of both consumer and corporate finance. Therefore, in the US, you've got a whole ecosystem of investors within private credit, be it at the mezzanine level, sometimes the senior level, or even at the equity level.

In Europe, we're just getting started on that. A real market has been developed, I would say, probably only in the last five or six years and we think there's a lot of growth potential.

Romil: Sticking with Europe then, Basel IV, or Basel Endgame, as it's also known, comes into effect from next year. How do you think this is focusing the minds of banks in Europe and the US, particularly around the structural need for European banks to deleverage? Has this led to an incentivisation among banks to engage in risk-sharing regulatory capital solutions like SRT, as well as other asset solutions like specialty finance trades?

James: It's definitely a big driver of the opportunities that we're seeing in the market right now. If I think of the SRT market in particular, depending on how you measure it, it was about US$ 20 billion in 2023. We expect that could easily reach US$ 30 billion in 2024. A lot of that growth will come from the US. The US is slightly behind Europe for a variety of reasons in terms of SRT issuance but also, potentially, the US banks don't have the same degree of capital needs as we see in Europe. Certainly, we expect to see significant European growth as well.

Also, the range of assets that we're seeing in the SRT transactions should grow as well. Traditionally, SRT is very much focused on the corporate lending market. That was where the highest capital charges were. Increasingly, we see the scope for consumer transactions as well.

We definitely feel the growth over the next few years should be pretty significant in this market.

Romil: Aside from SRT, what other routes of access are there for investors to capitalise on bank deleveraging opportunities and gain exposure to core bank loan assets?

James: This is really the asset portfolio sales. In addition to the need to become more capital efficient, which is obviously where SRT can really help, there's also a general need for banks to just reduce in size. We're seeing – and have seen in fairness for a number of years – banks looking to obviously move out of non-core activities, and also move out of non-core jurisdictions. That's creating a steady supply of opportunities to pick up asset portfolios in a variety of jurisdictions.

Even at the moment, we're looking at transactions in the UK, Ireland, Spain, Italy and we recently closed transactions in the Nordics. It's mainly consumer assets that we're focused on. I'd say, obviously, residential mortgages being the most popular, but also auto loans as well. We see some quite significant activity there.

Jo: Yes, as James notes we're seeing a lot of deal flow coming through in the areas that he's mentioned. It's probably worth also highlighting the fact that these asset portfolio sales tend to be non-standardised and less programmatic than we see in SRT markets. Obviously, this will come, of course – standardisation will come to the market as it evolves. For the time being, there's quite high barriers to entry, and this essentially makes it a purely private opportunity in terms of access.

Also given the fewer players and lower competition for assets in the space, especially for performing loans, this is also helping to maintain the return premiums for investors. The risk-return profile that we're seeing, particularly for consumer asset portfolios, has very much remained attractive and is likely to continue to do so as long as those barriers to entry exist.

I think the important thing for us is to focus on very granular asset portfolios. We very much like opportunities which give us a rich amount of data in order to analyse the opportunity and really understand the risk and return drivers. This is clearly very important for performance, but also gives us a way to understand the transaction to really maximise deal economics.

James: Thinking ahead in terms of the next few years around what we're likely to see in these markets, obviously we've touched on potential growth in the SRT market. I think as far as European asset sale growth goes, a lot of it is dependent on investors. The barriers to entry for asset portfolio sales, I would say, are even greater than they are within SRT, the need for specialist knowledge, the need to understand both the asset and the liability side of the capital structure.

These asset portfolios require a significant amount of ongoing servicing work and there are just literally very few players we think that are equipped to be able to do that. I think that market develops frankly as those individual managers who can manage those types of assets grow relatively steadily over the next several years, but I think it's really a case of, if the demand for assets is there, then they can be sourced, frankly. We certainly feel that the opportunity set is very large, but actually, if anything, the barriers to entry are quite significant.

Romil: Unfortunately, we're running out of time, but before we go, I'd like to come to you both to get a sense of how sizable the private asset-backed finance opportunity is and what are some of the top considerations to be cognisant of?

James: We think this is a really good time to invest. The European private asset-backed market has obviously been going for many, many years, but it's only in recent years where we've seen obviously the capital pressures that banks are facing sort of coming to the fore and also this real desire to shrink balance sheets. That's really created the wealth of opportunities that we're seeing right now and there really are significant numbers of transactions coming to market almost every week. I think the SRT market is definitely poised for significant growth over the next few years.

As I mentioned, the asset portfolio sale market is somewhat more governed by investor interest in that market, potentially in Europe and from elsewhere, but again the direction of travel is clear. I think particularly because you have these barriers to entry, because it is such a specialist area of investment. That's why we want to get involved in these assets – not because they're intellectually interesting. It's because we feel we're getting a much higher return than we can achieve in public markets and it's because of the complexity premium and because of, frankly, the expertise and specialist teams required to capture the opportunities.

Jo: I think from an investor standpoint, there's also a very large diversification [opportunity] that comes with investing in these assets. We think it makes strategic sense for investors to invest in these areas going forward. A lot of current portfolios are exposed to corporate assets via public bond and credit markets and most investors don't really have an allocation and we think this is going to change going forward.

James: I think in summary from my side, it's a very scalable opportunity that there is scope to put significant amounts of capital into both the SRT and the specialty finance markets. That's really, I think, the most important thing for investors to consider when looking at this market, it's definitely a multi-year opportunity. This is not something that is going to be around for the next year or two, this is definitely what we would term as a megatrend that will, I think, deliver assets to investors for the medium term.

Romil: Sadly we must leave it there for today's episode of *The Investment Podcast.* James, Jo, it's been a real pleasure. Thank you for sharing your detailed and granular insights on the compelling opportunities in these relatively new markets.

James: Thanks, Romil.

Jo: Thanks for having us, Romil.

Romil: Thanks to you, our audience, as ever, for tuning in. We look forward to seeing you next time, but it's goodbye for now.

Speaker 2: For further information, please view the notes which accompany this episode. This podcast is for investment professionals only. The value of investments will fluctuate, which will because prices to fall as well as rise, and investors may not get back the original amount they invested. Past performance is not a guide to future performance. The information and views expressed should not be taken as a recommendation, advice, or forecast.

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