

Active Portfolio Management A new success strategy for lenders

BY KINGSLEY GREENLAND AND GIFFORD WEST

Active Portfolio Management (“APM”) is the practice of continually reviewing the component parts of a portfolio to identify opportunities to increase return and reduce risk. Historically, banks have been able to pursue APM only for very large corporate loans and large pools of homogenous credits, such as residential mortgages. This has been accomplished using the syndication market, credit default swaps and/or securitisations. APM has been nearly impossible for heterogeneous or smaller credits such as commercial real estate and SME loans.

Today, liquidity for all asset classes is emerging and institutions of all sizes are beginning to pursue a strategy of APM across their entire portfolios. Because the friction in the transaction process has been reduced, the global community of investors both large and small is growing rapidly. These investors can now review and bid on a far larger number of assets than they could in the recent past. They are particularly drawn to the opportunity to purchase only those loans that meet their acquisition criteria; traditionally they were required to buy larger pools that inevitably contained credits they did not want to own.

The growing liquidity in previously illiquid asset classes is the result of fundamental reengineering of the due diligence process and the rapid growth of opportunity funds focused on smaller loan amounts. For the first time, the ability to trade smaller loans or pools of loans is giving banks the opportunity to pursue an APM strategy across their entire portfolios. Many of these changes can be attributed to the emergence of electronic platforms tailored to loan sales.

For lenders, APM is providing new strategic options to increase diversification, reduce exposure to industry sectors, improve overall profitability, as well as dispose of stressed or non-performing loans quickly and efficiently.

The virtues of APM

APM helps lenders in several strategic ways.

First, APM allows banks to adjust dynamically to market conditions by continually increasing or decreasing loan types to create the optimal portfolio mix, much like a stock portfolio manager adjusts in response to changing market conditions. Previously, banks could only respond by increasing or reducing their new origination activities, effectively lending their way out of a misadjusted portfolio. Now, with a change in the local economy, they can sell existing commercial real estate loans, for example, to immediately realign their portfolios.

Secondly, APM offers a new tool for addressing troubled loans. Historically, banks have used workout teams as their primary means of addressing non-performing loans. The new liquidity in the secondary market now gives banks an opportunity to value the loan and then make an informed decision whether to keep or sell it. The decision to use an in-house workout process can now be based on quantitative cost/benefit analyses.

Together, these benefits amount to a fundamental breakthrough in port-

folio management that enables institutions to achieve the Efficient Frontier of asset management. This economic principle holds that a diversified portfolio can deliver equal or greater returns with less risk and volatility than portfolios that are overly exposed or concentrated in one area. As a practical matter, institutions pursuing APM are now achieving that goal every day.

A new class of aggressive buyers

Electronic trading platforms have made it far easier to trade the debt of smaller companies or heterogeneous assets, such as commercial real estate mortgages. Technology enables much of the analysis, due diligence and bidding to be done more cost effectively. The result is greater transparency and thus a greater willingness to purchase debt that was previously attractive, but problematic.

Online trading exchanges have played a key role in bringing APM to this asset class by transforming a process that has been historically time- and labour-intensive. For example, loan documents are digitised and formatted with text searching and spreadsheet capabilities. Buyers can review securely a 3,000-page loan file online without travelling to a seller’s office to physically inspect boxes of loan documents. The streamlined process eliminates wasted travel time and enables investors to evaluate and bid on more loans in less time.

The efficiency of the process has drawn in buyers seeking to purchase smaller loans, and these investors have become a primary engine of market liquidity. In the past, the fixed costs of conducting a sale were too great to justify the sales of pools of assets under \$50m.

Now, institutions can sell individual loans as small as \$1m, and this has resulted in more money entering the secondary market. One reason for the expanded liquidity is buyers are increasingly interested in purchasing the exact amount of a specific type of credit risk they want, but no more. Another reason is buyers have repeatedly shown a willingness to pay more to own only what they want. Together, these factors are generating higher loan sale proceeds and a greater motivation to sell smaller portfolios.

Finally, the immediacy of online exchanges has created a new human dynamic in the marketplace that engages market participants and keeps them engaged as never before. The effect of real-time access to the market, competitive bidding and a daily flow of potential purchases makes a vibrant secondary market for loans.

The collective impact of greater liquidity and a more streamlined loan sale process is that APM is rapidly becoming just another capital markets activity, rather than an adventure. For credit managers, APM is now one of the sure paths to stronger results with lower risk. ■

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This article first appeared in *Financier Worldwide's April Issue 2005*.

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