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DE-RISKING EUROPE'S BANKS

HOW CHORUS HELPS THEM TO RECYCLE CAPITAL

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CAPITAL TALK

CHORUS CAPITAL

Photography by Peter Searle

A new dawn for Chorus

Gilles Marchesin tells **Andy Thomson** about the evolution of risk-sharing transactions and why a window of opportunity is open in 2017

CHORUS CAPITAL

Maybe it's because explaining risk-sharing deals is something of a complex undertaking that Gilles Marchesin, founder and chief executive of Chorus Capital, has so little time to spare that he zips around the London streets from one investor meeting to another on a scooter.

Seated in a corner of Chorus Capital's rather bijou boardroom, if Marchesin is weary of the task of explaining his firm's strategy, he hides it well with a broad smile. "It's basically about risk-sharing with European financial institutions," he begins. "We invest in performing loan portfolios from the core lending business of these institutions, using securitisation techniques to get the exposure."

Risk-sharing is the term preferred by Chorus Capital, but there are other names to describe the same technique – capital relief is one of them. What it boils down to is securitisation being used to extract credit risk from banks' balance sheets. The banks will place the equity tranche of the securitisation with an investor such as Chorus Capital, which takes the first-loss risk of a loan portfolio. Unlike with other types of securitisation where the full capital structure is placed, such as in a collateralised loan obligation, in this case it's only the equity, with the senior tranche retained by the bank.

"It's a capital management tool that more banks are using," notes Marchesin. "Banks have a big return-on-equity issue. The amount of capital they need to hold is going up, but profits are under pressure. They have piled up aggressively-priced loans as loss leaders on their balance sheets."

> "BANKS HAVE A BIG RETURN-ON-EQUITY ISSUE. THE AMOUNT OF CAPITAL THEY NEED TO HOLD IS GOING UP, BUT PROFITS ARE UNDER PRESSURE"

From a credit risk viewpoint, however, the loans are healthy and risk-sharing deals mean that the banks can "slowly but surely manage their capital allocation, recycle capital tied up in low-return activities and generate capacity for new lending".

The technology is not new. A former investment banker who spent 12 years at Goldman Sachs, Marchesin recalls that pioneers such as JPMorgan first used it around 20 years ago in transactions commonly referred to as synthetic balance sheet securitisations. "Back in the mid-90s, the idea was already to free up capital and lending capacity. You transferred the risk of loans to an outside party while keeping the loans themselves on your balance sheet and continuing to service the borrower/client."

The motivation was the same then as

now, driven by banks piling up unprofitable loans as part of a relationship banking approach to facilitate the cross-selling of ancillary business lines. However, also then as now, "they didn't want to notify their borrower clients the loan is not profitable so they're selling to someone else. With risk-sharing, you keep the asset but you get rid of some of the risk", points out Marchesin.

Retaining the asset on the balance sheet is a significant advantage, since the borrower/client is unaware that the risk has been transferred elsewhere.

"It tends to be the bank's portfolio management or treasury departments that do these deals, away from the commercial bankers. The assets stay on the balance sheet and the borrowers are not notified," says Marchesin.

With regulatory pressure on the banks increasing in the wake of the global financial crisis, the risk transfer market has been growing much bigger than it had been previously – and its structure has also evolved significantly. Until the late 2000s, many deals were being executed within the banking system – one bank transferring risk to another. "Post-crisis, the regulators wanted to make the banking system more robust and decrease the systemic risk, and that meant proper risk transfer outside of the banks," says Marchesin.

HUGE POTENTIAL

The potential size of the risk transfer market for non-bank participants is huge. "Overcapacity in European banking is arguably greater now than at the time of the [global financial crisis]," says Marchesin. He is backed by figures from ECB Statistical Data Warehouse showing that as of January 2017 the aggregate bank balance sheet size in the euro area stood at €31.2 trillion, 4 percent higher than in January 2008. The constraint is the investor base, which is too small currently to absorb the full number of potential deals.

"LOAN STANDARDS HAVE BEEN RELAXED OVER THE PAST FEW QUARTERS AND LOTS OF LOANS ARE STILL MADE AT AGGRESSIVE LEVELS TO PROTECT MARKET SHARE AND GET THE ANCILLARY BUSINESS"

"Balance sheets have grown and European banks' re-focusing on their core markets has magnified existing overcapacity," notes Marchesin. "Because of this overcapacity you have a lack of pricing power and that's great for borrowers. Loan standards have been relaxed over the past few quarters and lots of loans are still made at aggressive levels to protect market share and get the ancillary business. In an environment of low pricing power but relatively high lending activity [corporate lending by core European banks has been growing at twice the rate of GDP growth in recent years], you need to recycle all that capital tied up in loans which are healthy but generate a low ROE."

ECB Statistical Data Warehouse figures show that the stock of corporate loans on core European bank balance

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sheets has gone up by 3 percent in 2016, 7 percent over the past three years and 17 percent since 2008.

But while there is no lack of potential supply, only a limited number of asset management firms can deploy capital into the opportunity. This is partly because such deals may be too complex for those who have not done them before, requiring considerable knowledge of banking regulations, accounting and the structuring of risk-transfer transactions, in addition to the ability to analyse credit.

For most institutional investors, entering the risk-sharing market "is a big undertaking", says Marchesin. "It's sophisticated, and you need a big team with a specific skillset. For many pension funds in particular, it's also difficult to face banks directly."

There are exceptions. AXA was an early mover and PGGM has become a major investor, having first begun doing such deals around 2006. "[PGGM] saw it as an alternative way of investing in banks other than simply buying bank shares. They were not the first institution to do it, but they've built a big in-house team," says Marchesin.

€31trn
Aggregate bank balance sheet size in the eurozone as of January 2017

30
Estimated number of risk-sharing deals in Europe last year

€6bn
Estimated value of risk-sharing deals in Europe last year

But just because few institutional investors are willing to engage with the banks directly that doesn't necessarily mean they wouldn't commit indirectly through fund managers. And that's where the likes of Chorus Capital come in. Of course, deep experience of the market is a prerequisite – and is the reason why few funds are involved in the space. Chenavari Investment Managers and US-based Christofferson Robb & Company are among a small number of firms providing competition.

PIONEER

Faced with questions from would-be LPs about experience and track record, Marchesin, with 22 years of credit markets experience overall, can credibly claim the status of a market pioneer. When he notched his first risk-sharing transaction at Goldman Sachs in 2001, it was one of the very first that the bank had done

PREPARED FOR A HARD LANDING

Gilles Marchesin's approach when it comes to whizzing around London on his scooter might best be described as 'safety first'. He confesses that he has become the butt of jokes when arriving at meetings wearing a huge padded jacket arguably better suited to a machine with more horsepower.

As a time-saving device, the scooter is a valuable accessory for a busy man. "I work super hard because you have to try to work harder than your peers. I suppose I lead the standard life of a Londoner working long hours," he reflects.

However, with children aged 6, 9 and 11 and a "very happy family life", there is such a thing as downtime. When he gets the chance to indulge them, Marchesin's recreational pursuits include movies and concerts, tennis, yoga and skiing.

in Europe. Meanwhile, Chorus Capital's chief investment officer, Kaikobad Kakalia, ran the treasury team executing risk-sharing deals at Royal Bank of Scotland and ABN Amro. Skim through the CVs of other members of the 12-strong Chorus Capital team and you will find plenty of additional evidence of relevant blue-chip banking experience.

It was in 2011 that Marchesin saw the opportunity to launch a risk sharing-focused asset manager and decided to leave Goldman Sachs. The timing might best be described as interesting – just as the refinancing of Greek public debt saw Europe's sovereign debt crisis flare up once more. "It was pretty bad," reflects Marchesin. "I left Goldman without knowing exactly where our seed capital would come from, and the sovereign crisis didn't help."

Marchesin says he decided to concentrate on getting the team in place, hiring the credit analysts and structuring experts that he knew would be key to the firm's credibility. He spent a lot of his own money, while trying to raise capital on a deal-by-deal basis. A thankless task, but a necessary one: "This is not something you can do in a garage with a couple of guys," Marchesin insists.

Getting institutions engaged with the strategy was far from easy, given that it was "not at all mainstream" at the time. He attracted the attention of a large US hedge fund in 2013 which was interested in handing Chorus Capital a managed account, though the arrangement did not come to fruition. The following year, however, the firm was seeded by Woodman, a Switzerland-based asset manager – support which came not a moment too soon. "For over two years, we'd had a cost base but no revenues."

EDUCATION

Chorus is currently understood from market sources to be fundraising though the firm itself declined comment. Marchesin says the target net return to investors is 10 percent. Given the low risk arising from the performing loans that the firm invests in, this sounds like a high return figure.

He says it can be achieved because the investment is effectively an equity investment in a loan portfolio which stays on the banks' balance sheets. In addition, the firm reprices the loans against public market benchmarks. Nonetheless, he concedes that it takes time to educate investors on the investment opportunity, and that fundraising is not without challenges. "You have to lock the capital up for five years in exchange for a stable risk-adjusted return of 10 percent, but some investors want higher returns in exchange for committing for that amount of time."

Asked which types of investor might be expected to support Chorus Capital's strategy, Marchesin says those prioritising income generation, such as pension funds and family offices, are a big target. Most of the return is paid by way of quarterly income, with stable leverage provided by the banks (within the structure of these transactions) on a term, non-recourse basis.

On the other hand, he acknowledges that there is an "s" word in danger of causing offence. "Some don't like the word 'securitisation' because of losses from it in the past. But it's a tool that can be used for good and bad purposes, and what we do is not very funky. It's getting increasingly mainstream and people are getting more and more aware of it."

Indeed, there is a compelling reason for awareness to grow in 2017. As of next year, new rules to be implemented under the Revised Securitisation Framework – largely based on proposals published by the Basel Committee on Banking Supervision in December 2013 – will mean risk-sharing transactions becoming less efficient for the banks as the capital charge on the senior tranche will rise.

With deals done prior to the change expected to be grandfathered, Marchesin sees it as a big driver of activity through the remainder of this year. "We see 2017 as a window of opportunity, as the banks are being pushed to do deals now. Estimates suggest there were around 30 of these deals done in Europe last year, worth about €6 billion. We think there could be twice as many this year."

Beyond 2017, Marchesin emphasises the marginal capacity constraints in risk-sharing and has serious ambitions for Chorus Capital. "We will grow significantly over the next few years but we will stay very focused," he says. "We are a specialist asset manager, and that's the way we want to stay." ■