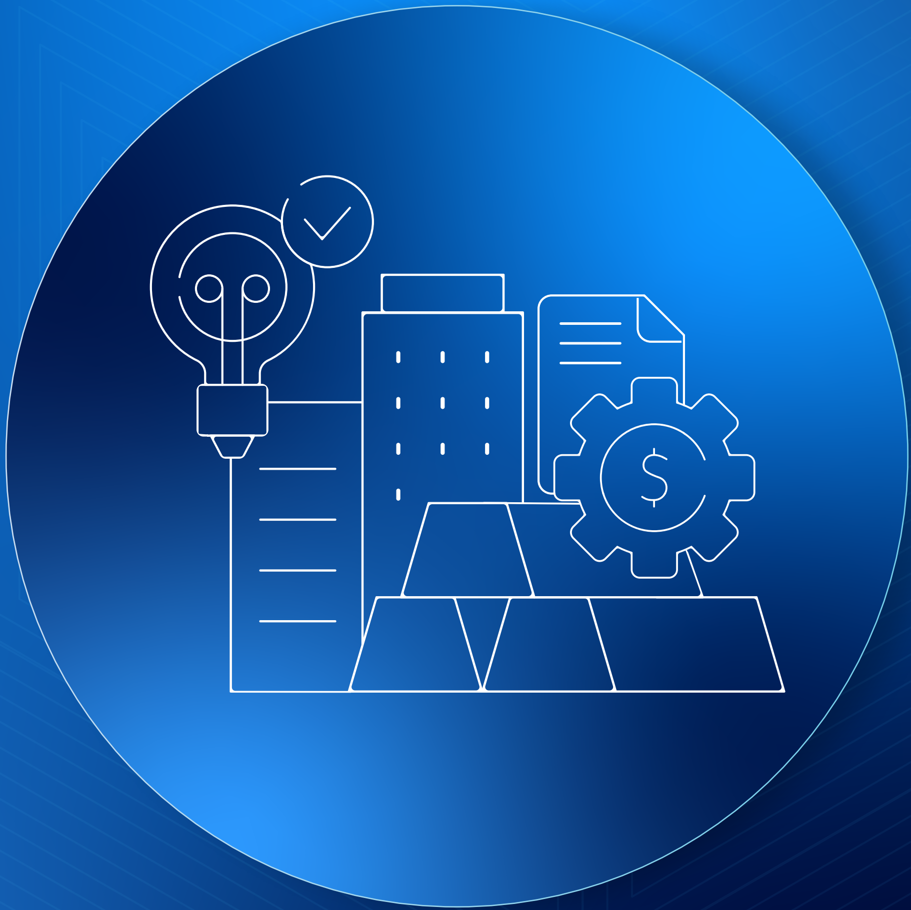
Solving the Operational Challenges of Asset-Based Finance

A Comprehensive Toolkit



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Introduction

Previously, we covered the basics of Asset-based Finance (ABF) and its projected growth. This toolkit digs into the operational challenges firms might encounter, depending on the asset classes chosen. For example, some of the most common asset classes firms might invest in as they launch and expand their ABF strategy include the following.

Consumer and commercial pools of loans

The consumer and commercial loan market is expected to grow to $2.5 trillion by 2033, with North America dominating the market (Market.us).

Benefits:

- Diversifies revenue streams and steady stream of interest payments, providing more stable income during market fluctuations
- Provides access to new markets, which is enhanced with the availability of reliable and comprehensive data from multiple lending platforms
- Produces higher returns as compared to traditional investments

What to look out for:

Managing performance across multiple lending platforms will lead to a high volume of data, which could jeopardize a real-time view of portfolio health if not properly consolidated.

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Residential loans

The global market for residential loans, primarily mortgages, is expected to reach $25 billion by 2030, achieving a 10% CAGR during that time (Fairfield Market Research). Other residential loans, such as mortgage refinance loans, are also expected to grow, with Asia-Pacific again expecting a surge in growth (Allied Market Research).

Benefits (Investopedia):

- Shares similar asset characteristics (e.g., maturity date), making it easier to standardize data for tracking
- Offers diversification depending on the geographic focus of the loans, property type, loan type, and so on
- Provides reliable cash flow and varying levels of risk and return

What to look out for:

Managing the performance of residential loans requires paying close attention to prepayment risk, when mortgage loans are paid off early or refinanced. According to Lending Tree, "Prepayment risk is typically highest when interest rates drop, causing many borrowers to refinance their loans."

Accounts receivable and trade financing

With a CAGR of 7.4% through 2032 for receivables and trade financing (Market Research Future), these asset classes show much promise, especially in North America where the market is expected to reach $8.5 trillion by 2032.

Benefits:

- Reduces risk with international trade finance instruments (e.g., letters of credit) for a safer and more predictable environment for transactions
- Offers expanded alternative funding sources, such as fintech platforms and supply chain finance, providing more flexible and innovative financing solutions
- Continues to grow more efficient and transparent through advanced technologies such as blockchain and AI, which can reduce operational costs and improve risk management

What to look out for:

Risks, such as geopolitical tensions, economic fluctuations, and regulatory changes, can impact trade flows, financing costs, and the overall stability of investments in the trade finance market. Firms should closely monitor global political and economic developments to manage potential disruptions and ensure the stability of their trade finance operations.

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Synthetic Risk Transfers (SRTs)

SRTs are projected to maintain a 18% CAGR through 2030, according to Pemberton. While Europe has spearheaded the market, North America is catching up as more issuance programs open up.

Benefits:

- Offers high financial returns, around 10% historically, and spreads typically ranging from 10-12% (Pemberton)
- Helps reduce overall portfolio risk through diversification
- Has shown high resilience to credit stress, which can be particularly valuable in volatile market conditions.

What to look out for:

The illiquid nature of SRTs might post an above-average level of risk and require long-term maintenance and specialized knowledge to understand and manage efficiently.

Non-performing Loans (NPLs)

Out of the assets presented here, NPLs are project to soar at a 53% CAGR, with North America accounting for the largest chunk (Cognitive Market Research). Small and mid-sized enterprises represent the fastest growing segment for NPL management solutions.

Benefits:

- Can be purchased at a significant discount, which can lead to higher returns
- Has potential of turning distressed assets into profitable ones by restructuring NPLs to improve performance
- Provides downside protection from underlying collateral, such as real estate, which can be liquidated if the borrower defaults improve risk management

What to look out for:

NPLs are high-risk, high-reward, requiring close monitoring of the lifecycle of transactions to have a clear and accurate view of financial positions.

Introduction

Litigation finance

According to Research Nester, litigation finance will reach an 11.1% CAGR through 2032, driven by "...the rise of emerging economies seeking financial assistance to pursue legal claims".

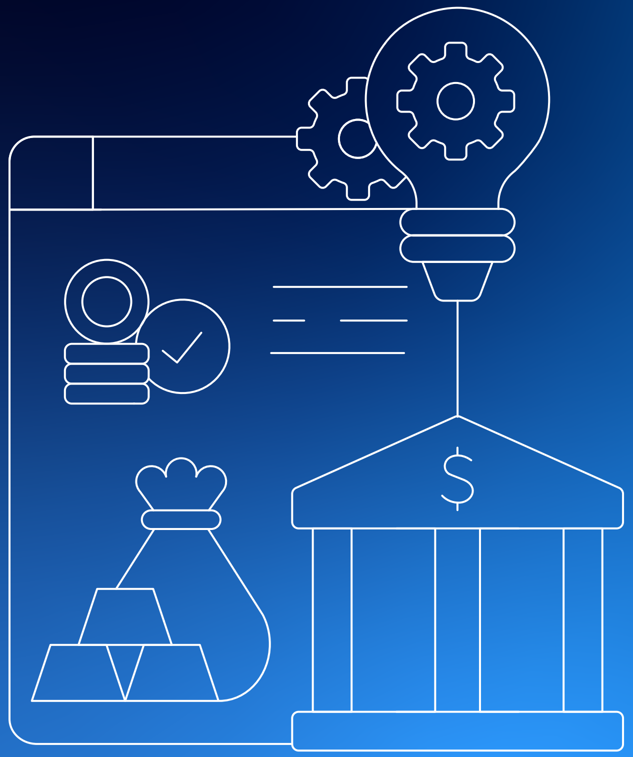
Benefits:

- Offers a unique risk-reward profile not tied to traditional market performance, enhancing portfolio diversification
- Has potential for high returns, depending on the type of legal claims
- Will continue to grow as the number of legal disputes increase and the need for alternative financing solutions drive demand

What to look out for:

Litigation finance is a fairly new asset class, meaning the regulatory landscape could quickly evolve, which could impact the viability and profitability of investments. Enhanced data security measures, detailed record-keeping, and adherence to regulatory requirements are necessary to mitigate these risks.

The top operational challenges with ABF and what to look for in potential solutions



Section 02

The top operational challenges with ABF and what to look for in potential solutions

Operational Challenge #1: Having the right operational and data infrastructure in place to support new asset classes across lifecycle events.

ABF brings a new level of complexity with managing thousands of new data points and high volumes of transactions from lifecycle processing. Firms must manage and process a wide range of loan lifecycle events, such as primary and secondary purchases, paydowns, reversals, charge-offs, and interest receipts. These events come from multiple sources, including alternative lending platforms, originators, and servicers, each with its own data format and structure. Outdated methods, such as manual data entry and spreadsheet usage, can lead to inefficiencies, errors, and difficulties in scaling operations. Moreover, the lack of standardized systems and universal protocols means that firms must develop or adopt tailored solutions to manage these new assets effectively.

Evaluation criteria for solutions:

- Look for advanced technology that can integrate with alternative lending platforms and fund administrators, ensuring seamless data flow and real-time visibility into positions
- Make sure your infrastructure supports comprehensive documentation, covenants, and cash-flow waterfalls to maintain transparency and compliance
- Verify that solution has a robust, adaptable, and unified technology infrastructure that can handle the dynamic nature of ABF and support the entire transaction lifecycle

The top operational challenges with ABF and what to look for in potential solutions

Operational Challenge #2: Centralizing performance analytics across all asset classes and lending platforms.

The diversity and complexity of ABF investment strategies require sophisticated systems to accurately track and reconcile data from numerous sources. Firms need to store and manage detailed loan terms and conditions, such as days past due, loan status, FICO scores, and total principal and interest received. This level of detail is crucial for applying portfolio-level policies for marking loans in and out of default. The integration of multiple fund administrators, custodians, and pricing providers adds another layer of complexity. Each stakeholder may have different systems and processes, requiring robust data mastering and ETL (Extract, Transform, Load) tools to handle new loan setups, security updates, and payment processing.

Evaluation criteria for solutions:

- Have access to NAV reports at any cadence (e.g., daily, weekly, monthly, etc.), removing any sole dependence on administrators
- Provide real-time view of positions at the loan level and various other levels (e.g., cohort, fund, etc.)
- Can evolve to handle new assets classes and lending platforms as they emerge to significantly enhance data management, operational efficiency, and decision-making

The top operational challenges with ABF and what to look for in potential solutions

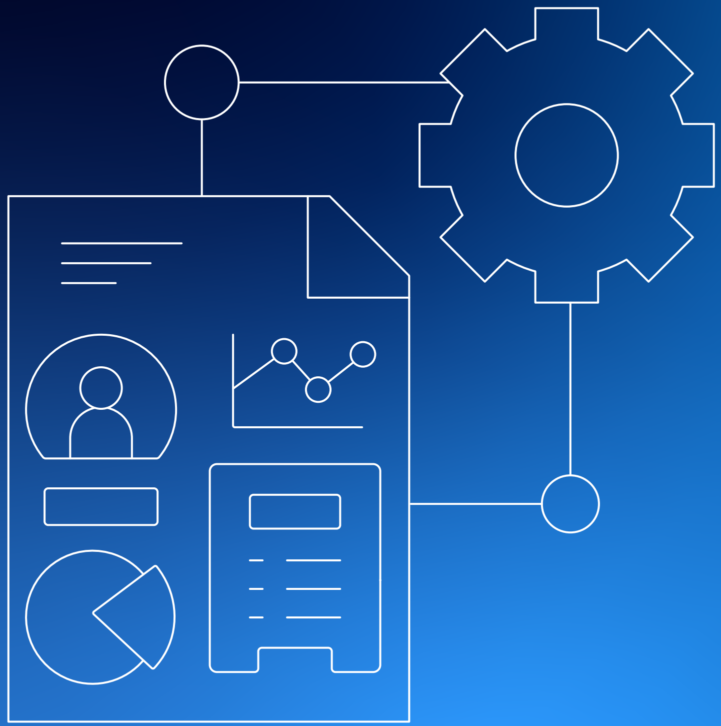
Operational Challenge #3: Shifting from internally built data operations tools to more scalable, less resource-intensive solutions to drive efficiency.

Firms often have multiple priorities, including managing different funds, dealing with various structures, and ensuring regulatory compliance. These conflicting priorities can strain resources and delay the implementation of new solutions, as the firm must balance the transition with ongoing operational demands. In some cases, different teams within the firm may handle various aspects of the same fund, leading to inefficiencies and redundancies. Coordinating these teams and ensuring a smooth transition to a centralized, scalable system can be challenging and may require significant organizational changes or outside help. Moreover, the need for a skilled team proficient in operations, compliance, and risk management, along with robust technology to automate and streamline processes, further complicates the task.

Evaluation criteria for solutions:

- Offer self-service tools to empower independent access to resources, reducing dependency on IT support and improving operational agility
- Provide fully outsourced, unified middle and back-office tech and services for asset back finance strategies across several fund products
- Enhance operational efficiency and improve reporting capabilities without straining current resources

A quick ABF operations plan cheat sheet



Section 03

A quick ABF operations plan cheat sheet

To effectively enter or succeed with ABF, firms should follow this basic operations plan:

Aligning people, processes, and technology

- **Team assembly:** Recruit a lean, skeleton team for exception-driven oversight and higher-level guidance
- **Transaction processing:** Leverage outsourcing or co-sourcing, with someone who has the same level of expertise, for non-core activities while maintaining stringent controls over critical operations
- **Process optimization:** Streamline operations through automation and implement robust controls to enhance process efficiency and reduce errors
- **Technology integration:** Adopt advanced technology solutions to improve operational efficiency, data processing, and transparency, which are crucial for managing ABF portfolios

Operational excellence

- **Cash and liquidity management:** Develop flexible strategies for managing cash flow and liquidity to adapt to market changes and funding needs
- **Performance tracking:** Implement systems for accurate and timely reporting of fund performance to stakeholders

Data management and integration

- **Data governance:** Combining different datasets together also presents data governance challenges, necessitating the need to ensure data integrity and standardization across the firm
- **Integration challenges:** Integrating via different file formats from different sources means the system needs to be flexible enough to adapt
- **System enhancements:** Be cautious of the strain that the volume of ABF puts on system performance and ensure the system is scalable

Collaboration with partners

- **Choosing the right partner/vendor:** Measure the ROI of your data, select high-value data vendors, and choose tech partners that have expertise in ABF
- **Collaboration with Partners:** Work closely with service providers and external partners for continuous alignment and tight oversight, ensuring seamless integration and communication

Compliance and Risk Management

- **Regulatory Compliance:** Stay abreast of and comply with relevant regulations that govern asset-backed financing to avoid legal pitfalls
- **Risk Framework:** Develop a robust risk management framework that includes regular risk assessments and mitigation strategies to protect against potential financial losses

Arcesium

Get in Touch

By focusing on these detailed components, firms will be well-prepared to launch and sustain operations in the asset-based finance sector in 2025 and beyond, with a strong foundation for scalability and operational efficiency.

Arcesium has a proven track record supporting asset-based finance strategies including large consumer and commercial pools of loans, residential loans, accounts receivable and trade financing, SRTs, NPLs and litigation finance. For these asset classes, Arcesium excels in supporting data sourcing from over 20 alternative lending platforms, originators and servicers, the mastering of these loans, transaction lifecycle management, reconciliations, and accounting and reporting all within a daily NAV environment.

Learn more about the future outlook of asset-based finance in our whitepaper.

Interested in seeing our data platform in action? Go to arcesium.com/submit-an-inquiry or scan the QR code.