

How Loan Sales Can Help Lenders Manage Distressed Debt

By Kingsley Greenland

Loan sales can offer an expedited path to health.

Are commercial lenders doomed in the current credit environment? While the market is clearly more challenging, the prognosis is better than it may appear. Growing liquidity in the secondary market for commercial and industrial (C&I) loans, commercial real estate (CRE) loans and consumer loans is providing lenders with a highly effective solution to restore health to their balance sheets quickly by selling distressed debt at attractive prices.

Underperforming loans are fetching higher loan sale proceeds for sellers because competitive bidding at online marketplaces has resulted in significantly more offers due to the simplicity with which investors can review and make bids. As a result, lenders are putting up more inventory for sale, and more buyers are entering the market each day. This continuous cycle of new supply and demand has propelled online loan sales into one of the most important components of distressed debt management.

The increased liquidity for underperforming loans is the result of a dramatic improvement in the loan sale process. Online loan marketplaces, which combine technology with the expertise and judgment of professional loan sale advisers, represent a fundamental improvement over all other types of offline loan sales, which have significant limitations for both sellers and buyers.

Three key reasons account for the accelerating liquidity of distressed debt at online marketplaces. First, lenders can sell loans in smaller face amounts, which has greatly expanded the pool of buyers. The reduction in the loan amount has enabled buyers to purchase exactly the pieces of debt they want. Second, lenders can sell loans to one bidder just as easily as to 10, thus creating more total bids and an aggregate sale price that is higher than if only a single

bidder purchased the entire amount. Third, buyers and sellers can trade more debt in less time because online due diligence streamlines the process, while standardized closings relieve both parties of the burden of individually negotiated legal documents.

To illustrate how increasing liquidity is helping lenders manage distressed debt, this article examines how three U.S. institutions went to the secondary market with slightly different strategies to dispose of underperforming loans. It explains the dynamics of the online loan sale in comparison to an offline sale, and it highlights when online loan sales should be used instead of a loan workout or an offline loan sale.

The Loan Workout Strategy: Benefits and Trade-offs

For many financial institutions, loan workout has been the primary way to manage distressed loans. That strategy has served lenders well when a troubled loan may need a quick fix. If workout professionals can turn around a credit with minimal time or effort, selling an underperforming loan doesn't make sense. A workout may also be the best solution when the institution perceives that a sale may hurt its reputation. With loan sales becoming an increasingly routine part of portfolio management, that perception is fading, but some clients still see it as a red flag.

While the workout strategy is appropriate in these circumstances, it is all too often the default strategy for many lenders. This approach comes at a signifi-

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cant cost. The workout strategy is time-consuming and expensive and requires significant patience and risk. Institutions must invest valuable management time to closely manage distressed loans, and that often puts a drag on performance. When a large volume of credits are in workout, valuable capital is locked up, and lenders have less liquidity to make profitable loans.

In addition, lenders that invest heavily in a loan workout strategy to the exclusion of loan sales are often viewed less favorably by the market. Even though a lender may be making progress in resolving problem credits, the balance sheet is still impaired. Investors typically assign a lower share price multiple to institutions with large portfolios of underperforming loans, even if the institution is responsibly managing the problem. Regulators also remain somewhat skeptical for a similar reason: Deadweight still resides on the balance sheet.

In spite of these shortcomings, workouts remain a critical component of managing distressed debt. Used in conjunction with loan sales, workouts allow an institution to aggressively and effectively minimize its portfolio of underperforming debt.

From Offline Sale to Online Sale

For institutions that want to sell loans, the key question is which type of sale is best: an offline sale or an online sale at an online marketplace? Both types of loan sales are appropriate in different situations, although many lenders still choose an offline transaction to sell distressed debt when an online loan sale would yield higher proceeds.

A lender should consider an offline sale of distressed debt when maximizing price is not the primary objective. In some instances, price is a secondary priority, as is the case when a large volume of loans needs to be sold. Just as an online sale is not the best way to sell a FORTUNE 50 company, the same holds true for a large amount of debt. The complexity of selling a \$15 billion portfolio to multiple buyers can be too difficult. In a transaction of that magnitude, conducting due diligence simultaneously with a large number of parties is asking for unnecessary complications.

Offline sales may also be preferable when the cost of due diligence is prohibitive. An investor who needs to spend \$5 million to review an opportunity—but could lose to another bidder by \$1—is unlikely to incur the expense because the risk is too high. In this instance, an offline sale is necessary. However, that, too, comes at a cost. Sellers are at a disadvantage because buyers know they have more leverage. Not surprisingly, the seller's proceeds in this kind of sale are lower than if there were multiple bids at an online marketplace.

Simplified Process for Sellers Leads to Greater Liquidity

An online marketplace provides the greatest number of options for sellers and buyers of distressed debt because of its efficiency and simplicity. At the same time, online loan sales can be used in combination with loan workouts or offline sales to effectively manage down distressed debt.

At an online marketplace, the loan sale process is easier, starting with the critical decision about whether to sell a loan or opt for a workout. An online loan marketplace is a central source of current market values because it accumulates vast amounts of transaction data. Each time a loan sale is completed at an online marketplace, it becomes part of the collective knowledge base. The loan sale adviser working with an online marketplace can readily access this information to help set the seller's expectations about the eventual sale price.

Lenders who try to determine loan values without the help of an online marketplace have a difficult job. Most lenders use models that are fundamentally flawed because they are subjective and lack current sales data. Fresh market data is tough to obtain because it is decentralized and is closely guarded by industry participants. At an online marketplace, current market values are easy to obtain and can provide a lender with a more accurate measure of a loan's resale value.

Once a lender decides to sell a loan, more marketing options are possible at an online marketplace. For example, a lender can divide a large loan or pool of loans into smaller pieces. Breaking up a loan into tranches gives investors with limited capital an opportunity to bid when they couldn't before. Instead

of having to purchase the entire amount, an investor can afford to bid on a smaller portion. Separating debt into individual components is also a better alternative for investors than offline sales. In those transactions, investors are forced to buy unwanted pieces of debt to get the piece they really want.

Smaller loan amounts have greatly expanded the universe of buyers. Reduced offering sizes have enabled investors with less substantial balance sheets to enter the market, make bids and consequently increase liquidity. At the same time, the standardization of documents at an online marketplace allows a lender to sell a single loan or pools of loans as easily to dozens of buyers as to one. When investors have the flexibility to purchase only what they want and nothing more, more bids are generated, and that leads to higher proceeds for the seller. In essence, the aggregate of many smaller bids becomes greater than if a single bidder purchases the entire amount. With robust liquidity, sellers can build loan sales into their portfolio management model. The cycle of liquidity thus fuels itself.

Streamlining the Process for Buyers Creates More Bidding

For buyers, an online marketplace makes it easier to purchase debt because the entire process has been streamlined, from identification of loans to due diligence to bidding and closing.

Online marketplaces make it easy to identify buying opportunities. Investors can go to an online marketplace to look for loans, instead of traveling around the country meeting with bankers. A single person searching for opportunities at an online marketplace can be just as effective—if not more so—than a five-member team perpetually scouring the country for debt. Greater efficiency in prospecting for loans reduces personnel expense and lowers loan acquisition costs.

Similarly, due diligence is more convenient and less expensive at an online marketplace than in an offline sale. All of the loan documents are digitized and uploaded to the online platform, so investors can review that information right at their desk. That reduces dead deal costs if the investor is outbid or if the investor declined to bid. In addition, because due diligence documents have been standardized,

investors don't waste time looking for information because it is in the same place every time. And, cash flow and future value modeling can be easily calculated for any prospective investment by using the financial tools built into the platform. Being able to run the numbers quickly permits buyers to look at more deals in less time, which leads to more liquidity.

Equally as important as streamlined due diligence is the simplification of the closing process. The purchase and sale documents can be standardized to be the same for each online sale. A condition of participating at an online marketplace is the agreement to use standardized transfer documents, which eliminates the time and expense of individually negotiated loan documents. The transfer documents, which are posted online, are accessible to legal teams for review in advance of the bidding. Standardized documents minimize the possibility of legal complications, while giving investors the confidence that there will be no surprises at the end of the transaction. By contrast, the negotiation of separately drafted legal documents is one of the key reasons that closings for offline transactions can take weeks or months, instead of up to five days at an online marketplace.

For lenders, the combination of loan workouts and loan sales can be very effective in revolving and reducing distressed debt. In the following three examples, lenders approached the management of underperforming loans differently, but were all successful in using online loan sales to achieve their ultimate goal.

One Loan at a Time

At a superregional bank based in the Midwest, a focused credit policy and willingness to sell loans online has helped minimize the recent turmoil in the mortgage market.

Recognizing last summer that a downturn was coming, this bank stepped up its loan sale program begun five years ago. Since then, the bank has executed a half dozen online sales of more than \$100 million. Because of the institution's reputation for credit quality, the loans consistently fetched a premium relative to their peers.

To tightly control nonperforming assets (NPAs), the bank has developed a clear criterion for action if a loan goes on the watch list. For about four in

five problem loans, a workout team is assigned to the credit. The other 20 percent are sold at online loan sales.

Recently, the bank's workout team successfully managed a \$20 million credit down to \$5 million. After repeated efforts, it became clear that the final portion of the credit could not be addressed in a timely manner. The bank then sold the loan at an online loan sale and eliminated the underperforming debt quickly at a satisfactory price.

The net effect for this institution: The combination of loan workouts and online loan sales proved indispensable for maintaining credit quality.

Managing to a Specific Number

At a regional commercial bank in the Northeast, the credit policy team is working through the current market dislocation by managing to a predetermined level of NPAs. The bank arrives at that threshold by looking at its historical level of NPAs and then actively manages that underperforming portfolio to a level below that of its peer banks.

By diligently monitoring its portfolio, the bank sells distressed credits before quarter-end to avoid the negative impact on quarterly performance. Over the past few years, this proactive strategy has translated into several loan sales annually, ranging from \$10 million to \$30 million. The bank's reputation for credit quality typically has elicited strong interest from investors as demonstrated by multiple bids and above-average sale prices.

The bank also views a loan sale as an opportunity for its workout staff to concentrate on credits where they can best add value. When the workout staff exhausts its options, the loan is typically sold, either individually or within a pool of other loans.

The bottom line: Online loan sales enable the bank to maximize its investment in loan workouts

and help maintain its target level for NPAs below its competitors.

Removing a Cloud Quickly

For a national securitizer of commercial and residential loans, an online loan sale in late 2007 proved highly effective in shedding exposure to warehouse credits after the securitization market went into gridlock.

Because of the liquidity crisis, the management team knew it needed to move rapidly to reduce credits that had fallen out of favor. Normally, the institution would have sold those loans in the securitization market, where it disposes of hundreds of millions of dollars of debt annually. But with the securitization market paralyzed, the management team turned to the secondary market—and was pleasantly surprised.

In the third quarter of 2007, more than \$50 million in CRE loans were sold at an online loan sale at attractive prices. The sale's success has led the management team to contemplate another sale of more than \$45 million.

The bottom line: A large loan sale helped the organization manage liquidity and retain balance-sheet flexibility. In the process, the institution realized that whole loan sales through an online marketplace can complement traditional securitizations to serve strategic and tactical objectives.

Plenty of Liquidity

Over the next few years, lenders are likely to see underperforming loans rise. They're also likely to face more pressure from regulators and shareholders to act decisively to eliminate problem loans—through loan sales, workouts or both. For institutions that attack the problem aggressively through a regular program of distressed debt sales, the reward will be lower NPAs; a stronger balance sheet; and, ultimately, a higher stock price.

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