

Portfolio Management: What We've Learned

In the United States and abroad, loan sales change the way institutions manage their portfolios

By **Kingsley Greenland**, CEO, DebtX

THE LAST TIME FINANCIAL institutions came under pressure from growing interest rates, President Bush had just taken office, the Sarbanes-Oxley Act was a year away and Google was a privately held company.

It also was a time when financial institutions still viewed loan sales as a last resort for eliminating subperforming loans or for diversifying their portfolios. For problem loans, many people still believed in the traditional hold-and-hope strategy — investing time and money in workouts in the belief that better days were ahead. As for diversification through loan sales, the idea was still in its infancy.

Since then, financial institutions in the United States and abroad have fundamentally changed their views on loan sales and the secondary market. One reason for this is that both have helped improve the way loan portfolios are managed.

Today, electronic trading of individual loans has become a multibillion-dollar international market because of its efficiency and liquidity. Global and regional institutions routinely execute loan-sale programs to manage everything from commercial real estate exposure to balance-sheet restructurings. The ability to generate a loan's current market value based on data from actual trades — an important byproduct of electronic trading — has solved the long-standing valuation riddle and has made it easier to sell loans.

Today's secondary market has also had a positive impact on the mortgage industry. In addition to creating an effective conduit through which money can flow from other capital markets, a functioning secondary market can help head off a credit crunch. With secondary-market liquidity as an escape hatch to get nonperforming

loans off the balance sheets, institutions can continue booking new loans.

Secondary-market liquidity benefits commercial mortgage brokers because it enables lenders to keep booking loans. When the market is active, brokers prosper.

As financial institutions look for ways to manage their portfolios in a rising-interest-rate environment, the time may be right to reflect on lessons learned in the United States and Europe. It may also be instructive to look at the ways in which the secondary market is enabling institutions to better manage their portfolios.

from much of the friction that previously made it difficult to execute these transactions. Initial pricing is easier because of the growing volume of comparable trade data.

Online marketing has broadened the reach of sellers and expanded the market. Further, standardized legal documents have shortened the closing process considerably. A growing local market of buyers, in addition to an active corps of international investors awash in money and attuned to new opportunities, have created a robust market in Europe, providing liquidity where there was none before.

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Looking abroad

In Europe, increasing global competition and consolidation have put European banks in a difficult position. During the past few years, they have been forced to clean up their balance sheets or face certain acquisition by stronger, healthier banks on the move.

Rather than wait for acquirers to do it for them, a number of large banks in countries such as Italy and Germany have taken the initiative. For the past few years, these institutions have been selling poorly performing debt from their balance sheets.

What changed the minds of bankers who had never been partial to such transactions? The ease with which institutions can price, market and sell loans that were previously considered illiquid.

Selling non- and subperforming debt in Europe is becoming a process-driven event free

The success of a few large banks has had a positive ripple effect across the continent. Mid-tier and smaller institutions have followed suit and are now selling loans, creating greater depth to the market.

According to *Financial Times Deutschland*, the first European loan sales were typically 1 billion euros (approximately \$1.36 billion U.S.) or more. With economies of scale, today the average loan portfolio sold on the secondary market is 50 million euros (approximately \$68 million U.S.) and dropping.

Concentrations at home

Since 2006, financial institutions in the United States have been under pressure because of the increasing concentrations of commercial real estate. Under scrutiny from regulators, shareholders and auditors, many financial institutions have been forced to alter the mix of their portfolios or suffer profit-and-loss erosion in the form of increased reserves.

But unlike past interest-rate cycles, more institutions are attacking the problem by leveraging the secondary market in two ways.

First, data from electronic trading is providing

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Kingsley Greenland is CEO of Boston-based DebtX, the nation's largest commercial loan sale adviser. He can be reached at kgreenland@debt.com or (617) 531-3400.

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current market valuations of loans to help institutions make better decisions — a quantum leap forward from the traditional method of loan valuation. Second, with better market intelligence about loans, it has been much easier for institutions to sell debt after they have determined whether it should be kept in the portfolio.

The ability to generate a current market value, rather than relying on internally generated estimates, is a new model for portfolio valuations. These valuations are the direct result of centralized loan trading and a greater availability of market analysis and data. With this data, an adequate basis of comparison now exists to do something close to mark-to-market valuations.

The arrival of market-based valuations has played a key role in helping institutions diversify their portfolios to address recent regulatory and shareholder concerns about commercial real estate. With a market valuation on a loan or on pools of loans, institutions have a more accurate picture of their portfolio. They can approach the potential sale of loans with greater certainty and fewer assumptions.



Independent market valuations are part of the broader dynamic that has transformed portfolio management since the last interest-rate cycle. That's particularly important in today's market, where consolidation and volatility demand that all institutions have a proven process in place to evaluate and sell loans. 