

## **Secondary Market for Debt - An Answer to the Credit Crunch?**

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As real estate loan losses continue to mount, financial institutions on both sides of the Atlantic face greater pressure to aggressively manage their loan portfolios to minimize the drag on earnings. How can they achieve this?

With the credit crunch likely to grow worse before it gets better, what are commercial banks doing in the face of this problem? Increasingly, the answer is to sell loans in the growing secondary market for debt. Powered by electronic trading, the global secondary market is now sufficiently liquid on a day-to-day basis to efficiently dispose of non- or poorly-performing debt, as well as high-quality, high-performing loans as part of normal portfolio rebalancings.

Loan sales have become a potent weapon because electronic due diligence, trading and closing allow competitive bidding of everything from multi-billion credits to loans or pools of loans as small as US\$1m. As a result, loan sales are now more attractive than the traditional solution of protracted loan workouts. Rather than incur the expense and management distraction of sticking with problem assets, it now makes more sense to sell and put the problems behind. The market's liquidity has translated into strong price execution, which makes a loan sale strategy all the more compelling.

In Europe, in particular, loan sales are becoming as common as they have been in US. In Italy and Germany, where the banking industry is fundamentally restructuring, financial institutions have sold billions of euros in loans into the secondary market. In the process, these institutions have emerged with strengthened balance sheets and can now compete vigorously as consolidation continues in European banking markets.

### **Efficiency Comes to the Loan Market**

Technology has helped create a secure, private multi-billion dollar online market for all types of commercial debt. Today, debt can be traded at a fraction of the cost and time compared to the traditional, offline environment because electronic trading has eliminated much of the friction in the process. The high fixed transaction costs that previously suppressed liquidity have largely gone away.

In an electronic environment, marketing and due diligence are especially efficient. Communicating with an international pool of buyers can be done quickly and cost effectively. Because the loan sale process has largely become digitized, buyers can perform due diligence online, which is faster and cheaper.

In previous years, due diligence required investors to make onsite visits to search boxes of loan documents, collateral information, appraisals, operating statements, court proceedings or other underwriting documents. If investors decided against making an offer, or another bid was accepted, travel expenses and management time went unrecovered.

At electronic trading platforms, investors can now view hundreds or even thousands of pages of loan documents online. Reams of documents can be easily searched, and sophisticated financial modeling is built right into the platform. From the comfort of their own office, investors can view and analyze a dozen or more deals in the time it takes to jump on a plane and fly to someone's office.

### **The Virtues of Dynamic Pricing**

Equally important, electronic trading offers dynamic pricing and allows small pieces of debt to be purchased for the first time. With online bidding, offers can be made in real time. Investors can adjust their bid as they see fit, rather than being locked into a single offer, which is typically the case in an offline, sealed-bid process. By driving down the fixed costs of the loan sale, investors can now purchase loans or pools of loans as small as US\$1m. Investors can now buy exactly what they want - and no more. In the past, investors often wound up with loans they didn't want, but were forced to buy because they were bundled and couldn't be sold separately.

Sellers have benefited handsomely from the market efficiency in the form of superior trade execution. In sharp contrast to the traditional process, in which investment bankers shopped loans to a handful of known buyers, electronic platforms have opened up the bidding process to many more investors. More buyers have meant more bids per transaction and ultimately higher prices. That's been very motivating for lenders.

Standardized legal documents for buyers and sellers have truncated the closing process and eliminated exorbitant legal fees. Sales that took 120 days or more can now be fully executed in 45 days.

### **The Art of the Sale**

Even with all of the technology powering electronic trading, the loan sale process still turns on human intervention and judgment. In fact, the liquidity in the loan sale marketplace is the result of marrying human expertise with technology. The art of the loan sale still exists, but with a distinctly 21st century flavor.

Human judgment plays a central role in the initial pricing. Traditionally, loan sale professionals used an informal 'friends' network to help set the offering price. Today, transaction data from thousands of trades is used by traders to set an initial price closer to current market prices. Technology has effectively minimized the guesswork and injected a welcome measure of transparency.

Human judgment is also critical for fielding questions from buyers. Because of the complexity in a loan sale, investors frequently need clarification about some point in the transaction. Without help from professionals who intimately understand the details, far fewer loans would be sold.

For institutions in both the US and Europe, selling loans in the secondary market is a smart new way to an age-old business problem. As this business cycle deepens, as more borrowers falter, lenders would do well to consider all of their options.