

Secondary Market Offers Another Option to Manage Loan Portfolios

By Kingsley Greenland and William Looney

An overview of the loan sale process, step-by-step.

As rising subprime default rates continue to spread havoc around the world, many financial institutions are being forced to overhaul their loan portfolios to reassure regulators, investors and the public. That normally challenging task is made even more difficult because of the paralysis in the securitization market—one of the usual conduits through which institutions eliminate loans from the balance sheet.

In an environment like this, what are commercial banks, pension funds, investment banks, specialty lenders and others to do? Answer: Turn to the growing secondary market for whole loans.

Over the past five years, financial institutions have used the increasingly liquid secondary market to sell commercial & industrial (C&I), commercial real estate (CRE) and other types of loans to a growing pool of hedge funds, insurance companies, opportunity funds and others. Powered by highly efficient electronic trading, the secondary market for whole loans has provided institutions with an opportunity to sell non- or poorly performing debt, as well as high-quality, high-performing loans as part of normal portfolio rebalancings.

This article outlines the benefits that financial institutions can realize by using the secondary market to manage their loan portfolios and explains the reasons for the exponential growth and liquidity in the secondary market due to the rise of electronic trading. The second part of the article provides a step-by-step look at the loan sale process.

Electronic Trading Transforms the Market

Loan sales have been part of portfolio management for many years, but it wasn't until technology was incorporated into the process that real liquidity emerged in the secondary market. The Internet, which enabled online trading and has given rise to electronic trading platforms with advanced decision-making tools built right into them, has significantly streamlined the traditional loan sale.

In the process, much of the fixed transaction costs have been significantly reduced, along with much of the friction that has traditionally kept bank portfolios illiquid.

In transforming the loan sales process for the digital age, transaction timelines are becoming shorter and far more efficient. By digitizing loan documents, buyers can now perform due diligence online, which is far faster and cheaper. Instead of making on-site visits to search boxes of loan documents, collateral appraisals, operating statements, court proceedings or other underwriting documents, prospective investors can do all of these tasks online in a fraction of the time. Reams of documents can be easily searched using the modeling and search capabilities embedded in a trading platform. From the comfort of their own

Electronic platforms open up the bidding process to investors around the world.

Kingsley Greenland is President and Chief Executive Officer of DebtX, Boston, Massachusetts. Contact him at kgreenland@debtX.com. William Looney is Executive Vice President, U.S. Loan Sales, at DebtX, Boston, Massachusetts. Contact him at wlooney@debtX.com.

offices, investors can now view and analyze a dozen or more deals in the time it takes to fly to someone's office and personally examine records. That savings not only allows investors to review more details but also enables buyers to eliminate the sunk costs and management time in bids that are not accepted or bids that are never made.

At the same time, electronic trading enables dynamic loan pricing and allows small pieces of debt to be purchased cost effectively. Because the fixed costs of the loan sales are dramatically lower, it becomes possible to sell loans as small as \$1 million. Before the efficiencies of electronic trading, only pools of loans of \$50 million or more could typically be sold because of high fixed costs.

Equally as important, 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 loans were bundled together. Now investors can purchase loans with greater precision, which further lowers costs and improves the deployment of capital.

Superior Trade Execution

Of all the benefits of electronic trading, superior trade execution may rank as the most significant. In sharp contrast to the traditional loan sale process, in which investment bankers shop loans to their network of associates, electronic platforms open up the bidding process to investors around the world. The broadening of the market has resulted in additional liquidity, while creating a new measure of transparency in the marketplace that didn't exist before. With more buyers and more bids per transaction, assets are typically fetching higher prices for sellers.

From a risk management standpoint, greater liquidity has allowed institutions to improve the way they value their portfolios. Rather than rely on internally generated valuation models, financial institutions can tap in to a central repository of market data that enables them to value assets based on recent market comps. That development has been warmly welcomed by regulators and ratings agencies, which continue to urge institutions to use the secondary market to enhance the management of their portfolios.

Electronic trading has dramatically shortened the time from offer to closing from 120 days to about

45, and closings are expedited. A key reason for expedited closings is that participating institutions are now using standard legal documents to settle all transactions. Those legal documents are available for review by attorneys before a transaction. That efficiency has all but eliminated the need for individually negotiated closing documents. More than 200 financial institutions and a like number of buyers have successfully executed transactions based on those standard documents.

The Critical Importance of Human Judgment

While electronic trading has brought new efficiencies to the loan sale process, human judgment is still indispensable. Experienced loan sale professionals play the central role in helping institutions identify the types of loans that can be sold successfully, in setting the initial loan price and in smoothly managing the process for both sellers and buyers.

In setting the loan pricing, loan sale advisers have traditionally relied on their market savvy and experience, but electronic trading has significantly improved the art of loan pricing through the introduction of objective data. Loan sale advisers today analyze data from thousands of transactions before arriving at a starting price for a loan. Before electronic trading, it was difficult to obtain market comps because sales data was scattered across the industry and wasn't stored in an easily usable or accessible format.

The Loan Sale Step-by-Step

Electronic trading and human expertise have collaborated to create an unprecedented level of liquidity for institutions in the United States and Europe. While the loan sale process may vary somewhat by region or continent, the major parts of the transaction are largely the same. The step-by-step description below outlines the role of the seller, the buyer and the underwriter acting as the seller's agent.

Initial pricing. A preliminary pricing analysis enables sellers to understand the recent market for similar asset sales and helps the underwriter understand the seller's expectations. The price analysis takes into account a wide range of quantitative and

qualitative factors, such as the dependability of the financial stream, quality of collateral, loan-to-value ratio and debt-service coverage, among others. The relevant financial factors considered include interest-rate trends, yield, whether it is a fixed or floating instrument and prepayment protection.

Complementing this empirical data is the qualitative analysis gathered from a loan officer's narrative accompanying an asset and/or the written summaries provided periodically to credit-rating agencies. As a general rule, the pricing process can take as little as a day for simpler loans, such as a pool of residential real estate loans. Or it can take several days or even a week for more complicated loans, such as a CRE transaction. The reason is that residential transactions involve analysis of fewer variables than a CRE sale.

Portfolio underwriting. Once an institutional seller agrees to proceed with a sale after a pricing review, the next step is to draft the underwriting documents used to market the loan. The two-page to three-page underwriting document summarizes all of the critical information. The synopsis is intended to give buyers enough information to quickly ascertain the asset's value and decide if they should bid. Typically, the document does not include the price, which is to be decided later by bidders in the open market. Increasingly, underwriting documents are being standardized into readily identifiable sections that allow buyers to find the same information in the same places for each transaction. The standardization of offering documents is one of the key reasons for greater liquidity in the secondary market.

Marketing campaign. Once the underwriting circular is prepared and due-diligence information and transfer documents are completed, the underwriter kicks off the marketing program in earnest. To attract the greatest number of buyers, investors are contacted by phone, are met in face-to-face meetings and receive e-mail and regular mail. The transactions are frequently advertised in leading trade journals. Dedicated salespeople contact investors who have expressed interest or who would be ideal buyers for a specific loan type.

Using technology, loan sale advisers can reach prospective buyers very efficiently because they

can provide timely updates by e-mail and target investors with specific interest in individual kinds of loans. When investors register online to participate in a sale, they will indicate the exact types of loans in which they are interested. Because many individuals can register from the same institution, it's easy to target multiple units within that institution. Highly efficient marketing creates a larger pool of qualified investors.

Online due diligence. While underwriting documents are being prepared, a seller is also working closely with the underwriter to convert hundreds or even thousands of pages of loan documents into digital files. These documents, usually provided to an underwriter in hard copy or in various elec-

tronic formats, include original loan documents, collateral appraisals, operating statements, court proceedings or other information that supports the original underwriting process. Once digitized, these documents are

supplemented with search and spreadsheet capabilities, so information can be downloaded to conduct online due diligence. Online access eliminates the time and expense of physically inspecting the loan files. Underwriters also provide financial models to enable buyers to carefully analyze the revenue stream.

Preparation of transfer documents. To streamline the loan sale process, a selling institution typically uses a standard purchase and sale agreement provided by the underwriter. The seller's consent to use this neutral, standard document is another important factor in creating liquidity. Once the seller has agreed to conduct a sale, transfer documents are posted online to allow a buyer's legal counsel to review the document ahead of time. By making documents accessible in advance, buyers and sellers minimize the possibility of litigation and help ensure that the transaction proceeds in a fair and straightforward manner.

Handling investor inquiries. As the marketing campaign continues, investors typically have some questions about an asset for sale. Traditionally, those inquiries have been directed to the seller, who may not have the capability to effectively

The standardization of offering documents is one of the key reasons for greater liquidity in the secondary market.

handle information requests. In fact, the volume of calls about assets for sale has been one of the most onerous tasks for sellers. Online underwriters typically handle those questions for the seller. That shift in responsibility to the loan sale adviser has helped increase the quality of the underwriting. The more questions that can be answered in writing, the smoother the transaction process and the more deals can be done.

Competitive bidding. Bids are submitted by investors through an online sealed bid or an electronic "e-cry" format. Typically, the seller and underwriter work closely to determine the format that will maximize the proceeds of the sale. That decision is based on recent market transactions and the underwriter's understanding of various bidding formats. (A seller can also choose an offline format in a sealed-bid process.)

The most common types of auctions are executed by a sealed bid, which can be done online, or by a live online auction. In the sealed bid, buyers generally give their best bid first and aren't allowed to increase it. In an open, e-cry auction, bidders can increase their bid in response to other offers they are seeing in real time on their computer screen. Generally, quality performing assets will generate higher proceeds under an e-cry format, while underperforming loans tend to generate higher proceeds in a sealed-bid format.

Bid award. Successful buyers are selected when

the bidding ends. In most instances, a loan will be sold to the highest bidder, but in rare instances, a seller may choose another buyer if there is a question about the buyer's ability to close the transaction. With a live e-cry format, bidders see for themselves who has won at the conclusion of the session. In a sealed bid, the buyer is notified by the underwriter shortly after the bid deadline.

Closing. As soon as the seller accepts the winning bids, the buyer must post a large, nonrefundable deposit. The closing usually occurs within five business days. Before standardized documents were incorporated into the online sale process, a closing normally took 40 to 50 days. Standardized closing documents facilitate quick approval from both attorneys and business principals.

A New Day for Portfolio Managers

The streamlined loan sale process has been responsible for the accelerating liquidity in the marketplace. These process improvements represent a breakthrough for financial institutions of all sizes because they improve portfolio management, lower risk and make available more strategic options. In uncertain times, that can be very comforting.

This article is reprinted with the publisher's permission from the COMMERCIAL LENDING REVIEW, a bi-monthly journal published by CCH, a Wolters Kluwer business. Copying or distribution without the publisher's permission is prohibited. To subscribe to the COMMERCIAL LENDING REVIEW or other CCH Journals please call 800-449-8114 or visit www.CCHGroup.com. All views expressed in the articles and columns are those of the author and not necessarily those of CCH or any other person. All rights reserved.