GARNET CAPITAL ADVISORS

Due Diligence is Crucial When Considering Loan Sales

WHITE PAPER

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Introduction

Loan sales can significantly benefit banks and other financial institutions, whether these organizations want to bolster their income by buying portfolios or free themselves up to issue more credit by selling them.

However, sellers will need to be familiar with the current compliance environment, which is intricate and constantly evolving. Sales that fail to address and successfully navigate this framework of rules and regulations can run into many different problems, including lowball price offers, failure to close and reputational damage.

To avoid these pitfalls, companies must perform the necessary due diligence and examine the many costs and benefits that come along with loan sales prior to entering the market. To start out, it may be beneficial to take a look at the history of these transactions.

A Brief History of Debt Sales

Loan sales are not new. The sale of loans and portfolios of loans dates back to the origins of the lending industry. The institutionalization of this market, however, is only a few decades old. The debt sales industry, especially sales of distressed debt, dates back to the 1980s, when the savings and loan crisis made such a sector necessary. While the causes of this event can be disputed, one thing is certain: bank failure was rampant during the period.

Between 1980 and 1994, more than 1,600 commercial and savings banks backed by the Federal Deposit Insurance Corporation either closed or obtained government assistance, according to the FDIC. This figure was remarkably high when compared to any other period since the government created federal deposit insurance in the 1930s.

In an effort to get these assets off the FDIC's balance sheet, the federal government stepped in and established the Resolution Trust Corporation in

1989. This government entity was tasked with selling failed banks' loans and securities to the highest bidder. RTC was highly successful in this endeavor, selling roughly $450 billion in assets between its creation in 1989 and its closure in 1995.

These assets required significant capital to purchase, and their effective management required professional management. These needs combined with opportunity for return to draw institutional buyers to the market where there previously was only private capital being deployed.

The FDIC sold the loans of many banks that had closed, and often – once the banks had shuttered their doors for good – their electronic systems went dark, too.

Incomplete Paperwork a Common Problem Among Early Loan Sales

While the FDIC was able to generate substantial transaction volume by establishing the RTC, this move also created some challenges. The FDIC sold the loans of many banks that had closed, and often – once the banks had shuttered their doors for good – their electronic systems went dark, too.

This situation often resulted in the firing of the bank staff that had been servicing and collecting the loans and incomplete transfer or elimination of electronic records that contained a history of all payments made. This situation made it extremely difficult to determine whether the borrower was current or late on their responsibilities. Individuals who owed money were frequently caught in a situation in which they wanted to pay back their debt, but did not know who to contact to do so.

Here's a common example of the inadequate information many had: Debt buyers had to examine boxes full of documents to identify borrowers, contact them and review available repayment options, and in some cases, loans were sold as nonperforming even though the borrower was willing and able to provide timely payments but lacked the proper contact information.

During the 1990s, the market for loans progressed substantially. Technological advances permitted industry participants to vastly improve the documentation of balance and pay histories. Banks became more tech-savvy as companies across all sectors moved forward in this regard, and over time, electronic servicing systems retained far more data that was readily available to debt buyers. Document imaging became the standard, and electronic storage and transfer of loan documents became progressively easier and more accurate.

Credit Card Use Rises

As the technology behind servicing loans and loan sales advanced, debt demographics also evolved.

As the technology behind servicing loans and loan sales advanced, debt demographics also evolved. In 1970, only 18 percent of households owned a bank credit card, according to figures contained in a Federal Reserve article titled "Credit Cards: Use and Consumer Attitudes." However, this figure surged to 68 percent by 1998. In addition, while only 37 percent of cardholders held a balance on one of these cards in 1970, 55 percent did in 1988.

In the next decade, the trends surrounding credit cards changed once again. Halfway through the 1990s, the delinquency rates on these methods of payments rose sharply, according to figures from the New England Economic Review. During the first quarter of 1995, 3.5 percent of credit cards were delinquent. By the same time in 1997, this figure increased to 4.5 percent.

Charge-offs also grew, which put pressure on the resources of lenders and market participants involved in debt collection. In these circumstances, many financial institutions started using debt sales as a form of inventory management.

By selling their loan portfolios, lenders were able to trim their costs by reducing the number of workers needed to service these assets. In addition, they were able to eliminate the need for more infrastructure.

Debt Sales Industry Sustains Momentum

Since that time, debt sales activity has remained robust. In 2011, debt buyers generated $3 billion in revenue, according to CreditCards.com.
In addition to sustaining significant transaction volume, the market for loan sales has become increasingly sophisticated over time. Organizations that buy debt have become far larger in scope, expanding to the point where they have larger distressed portfolios and greater product expertise than the original issuers.

Because of their size, these companies have the ability to make greater investments in research and compliance than the entities that issued the credit in the first place. In addition, their scale has allowed them to reduce their cost of funds. This development makes the industry more efficient, and allows sellers to get higher prices.

The vast majority of mainstream loan sales that happen today contain a large amount of reviewed data and documentation that is provided to buyers as part of the closing process.

State of the Market

In spite of all these positive developments, collecting and/or selling debt sales are both subject to increased regulatory scrutiny and oversight. Organizations involved in these activities could encounter a wide range of problems, both regulatory and reputational.

Even if a company decides to keep its debt instead of selling it, the organization is subject to substantially the same risks; as an example, firms can be held accountable for the actions of their vendors. As a result, selling to a debt buyer carries similar risks to placing an account for collection with a debt collector. In both cases, performing upfront due diligence and ongoing monitoring goes a long way in reducing risk and addressing regulatory concerns.

Amid all this, CreditCards.com reports that some market participants are having a hard time getting the information they need on purchased debt. When companies buy loans, they sometimes end up with electronic records that contain little information. Sales of this ilk are often poorly constructed, ill-prepared for the market and are most likely to trigger regulatory scrutiny. Care must be taken in the review and setup process to accurately describe and document the loans being sold.

The vast majority of mainstream loan sales that happen today contain a large amount of reviewed data and documentation that is provided to buyers as part of the closing process. Buyers often have access to all the information regarding an account from origination to the date of sale.

Government Regulators Shift Focus to Protecting Consumers

"Bank by bank, they understand it's going to be a higher bar."

– KATHY GOULDIE
The Office of the Comptroller of Currency

Amid these changing market dynamics, many regulators have started scrutinizing the activities of banks, collection agencies and affiliated organizations in an attempt to protect borrower rights.

The Office of the Comptroller of Currency has contributed to this push by providing bank examiners with a four-page set of best practices they can use when evaluating banks' debt sales, according to American Banker.

Kathy Gouldie, lead retail credit expert for the government agency, commented on the report and the higher standards that financial institutions will need to hold, the media outlet reported.

"Bank by bank, they understand it's going to be a higher bar," she told the news source.

The OCC is not alone in its efforts to monitor debt sales. Several other regulatory bodies are involved, including the FTC, the CFPB and other state and local agencies.

Financial institutions must keep in mind that if they outsource collection activities or sell their loan portfolios, they could be liable for the actions of third parties. The OCC and the CFPB have been instrumental in driving this change. As a result, if a lender sells or places its debt, the organization can be held accountable for the actions of the repossession agents, external lawyers, collection agencies or anyone else who has contact with the consumer.

Benefit of Holding a Comprehensive Debt Sale

Market participants that want the best possible chance of overcoming these challenges should consider undergoing a comprehensive debt sale process with an experienced broker. By doing so, financial institutions can get the best possible price and also minimize putbacks.

Garnet Capital Advisors has spent decades developing loan sale best practices, and has invested years into establishing best-in-class data security and written policies that reflect the concerns of regulatory agencies.

If financial institutions want to feel comfortable selling loans, they should be sure to address the major points that regulators focus on. The government agencies use various methods to provide updates on such matters, and Garnet monitors these sources constantly so it can remain current on compliance matters. In addition, the company has developed a 42-step written process to assist financial institutions in steering clear of issues that would concern regulators.

Garnet puts substantial due diligence into every loan sale, helping sellers successfully navigate the compliance environment. In addition, Garnet has experience orchestrating deals that cover the full range of loan types. The brokerage transacts portfolios that involve commercial, consumer and residential debt. In addition, it covers all quality types, including performing, distressed and charged-off debt.

Financial institutions should keep in mind that mishandling a loan sale can cause problems far beyond simply losing money in a depressed purchase price. Conducting a loan sale without incorporating recent regulatory laws, regulations and guidance could damage a firm's reputation, and also cause it to lose substantial amounts of time and cost remediating the problems.

If financial institutions wish to remain compliant, they must adhere to a framework guided by regulatory announcements, actions and postings regarding loan sales. By working with Garnet, firms can benefit from Garnet's constant monitoring of the loan sale environment.

In Garnet's opinion, government agencies perceive debt sales as a useful tool, but want to see them conducted in a compliant manner.

Loan Sales Generating Record Prices

Market participants should keep in mind that even with all these potential pitfalls, loan portfolios are generating record sale prices. However, companies that want to sell their debt for top value in this market need to incorporate compliance guidelines, laws and regulations into their loan sale process.

Financial institutions that want to take part in these transactions have many variables to consider. For example, bids can cover a wide range of prices and contract issues. To generate the best possible price and effectively manage risk, a seller must have intimate knowledge of the market. Garnet will lend their market experience to assist sellers with this process.

Garnet Offers Value

Garnet is one of the hardest working firms in the business, and its attention to detail, knowledge of loan portfolios and close personal connection with clients make it stand out. The company also benefits from substantial experience, with a team of seasoned professionals and senior management members who have worked together for over 20 years.

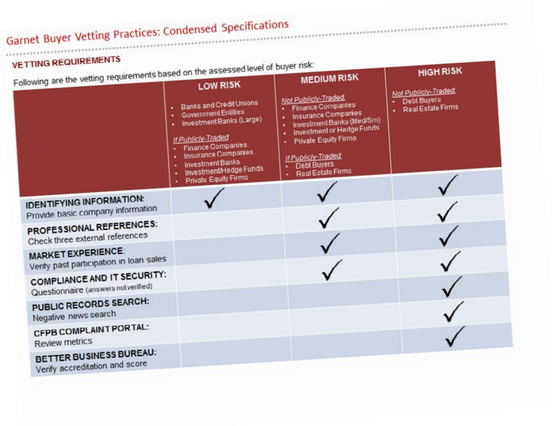
Garnet has an exemplary record, having never been involved in a lawsuit or regulatory action related to loan sales or business practices. In addition, the firm has never suffered a data breach and has passed the data security requirements of the FDIC and most major banks.

Over the years, Garnet has helped set up tens of billions of dollars' worth of deals. The organization boasts a pull-through rate on closing loans offered to the market of more than 90 percent. Between 2010 and 2013, the company did exceptionally well in this area, closing 96 percent of all commercial and residential loan sales brought to the market. Charge-off sales had a higher percentage close rate.

In addition, Garnet has performed very well in terms of charge-off repurchases. While sales of this debt frequently have a putback rate between 5 and 10 percent, less 1 percent on average of these portfolios sold by Garnet are bought back.

Three Crucial Areas Where Working with Garnet Adds Value

In the lead up to a transaction, Garnet reviews, data checks and prepares a portfolio for sale, so that the seller knows the current market pricing and contract points to ensure a deal is legitimate and has a high chance of closing.



Garnet Buyer Vetting Practices: Condensed Specifications

VETTING REQUIREMENTS

Following are the vetting requirements based on the assessed level of buyer risk:

	LOW RISK	MEDIUM RISK	HIGH RISK
	• Banks and Credit Unions • Government Entities • Investment Banks (Large) *If Publicly-Traded* • Finance Companies • Insurance Companies • Investment Banks • Investment/Hedge Funds • Private Equity Firms	*Not Publicly-Traded* • Finance Companies • Insurance Companies • Investment Banks (Med/Sm) • Investment or Hedge Funds • Private Equity Firms *If Publicly-Traded* • Debt Buyers • Real Estate Firms	*Not Publicly-Traded* • Debt Buyers • Real Estate Firms
IDENTIFYING INFORMATION: Provide basic company information	✓	✓	✓
PROFESSIONAL REFERENCES: Check three external references		✓	✓
MARKET EXPERIENCE: Verify past participation in loan sales		✓	✓
COMPLIANCE AND IT SECURITY: Questionnaire (answers not verified)		✓	✓
PUBLIC RECORDS SEARCH: Negative news search			✓
CFPB COMPLAINT PORTAL: Review metrics			✓
BETTER BUSINESS BUREAU: Verify accreditation and score			✓

Next, Garnet reaches out to contacts in its database, which contains relationships that staff members have developed during their decades in the business. This outreach includes institutions and other organizations that have been interested in similar sales, have indicated their interest in their Garnet registration or have been identified by Garnet research as potential purchasers of a specific portfolio type. Personal contact is made with buyers, ensuring that they have received and understood the opportunity. This hands-on approach continues throughout the due diligence process and up to the day of the bid.

The Garnet process continues by taking the sale from bid day to closing. The loan broker provides a comprehensive service, and market participants must keep in mind that after potential buyers submit their bids, there is still substantial work to do. At this point, Garnet employs its vast experience and keen attention to detail to rapidly move the process to closing. As a result, the slippage of price and time that frequently plague sales are avoided.

If a financial institution is considering taking part in a loan sale, it should do it the right way. Working with a professional, experienced broker can save an organization a lot of time, energy and hassle. Garnet fits the bill with its knowledgeable staff, strict attention to detail and broad industry contacts.

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