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Government & Public Services
Regulatory Compliance & Operational Risk

At auction: Asset management and disposition strategies and risk considerations for federal credit programs

March 2024

Executive summary

In 2024, US businesses and consumers face several crosscurrents with unknown effects on the current economic cycle. They include the tightest monetary policy in a generation resulting in high interest rates and borrowing costs; an inflation shock that is easing; spending runoff of COVID-19 pandemic financial assistance; and a resilient, but softer labor market compared to 2020–2022 (the Great Resignation). The US economy has seemingly eluded a post-pandemic recession despite widespread expectation of one due to the Federal Reserve's (Fed) rapid monetary policy tightening to curb inflation that peaked at a 40-year high of 9.1% in June 2022[1]. Although the US economy has avoided a recession, the same cannot be said for some cyclical industries that are particularly sensitive to monetary policy. For example, the US housing sector remains in a slump driven by high mortgage rates that have crimped buying power and decreased existing home sales to a near 30-year low[2].

For companies and individuals that have received financial assistance in the form of direct loans from US federal agencies or US-guaranteed loans from third-party lenders—totaling more than $2 trillion[3]—deterioration in economic fundamentals such as higher unemployment or inflation can spill over and put upward pressure on loan delinquency rates. As such, federal agencies should be ready to assume, manage, and dispose of performing and non-performing assets in order to maintain sound federal credit program performance, manage program subsidy (cost) rates, and promote positive outcomes for borrowers and third-party stakeholders such as lenders and investors. In this report, we define asset management and disposition (AM&D) strategies federal agencies can consider to effectively manage risks to federal credit program performance. Specifically, we summarize these strategies, corresponding risk management considerations for federal credit programs, and provide a general outlook for the following topics:

- AM&D strategies
- AM&D risk considerations

Asset management and disposition strategies

There are several strategies that federal agencies can implement to manage or dispose of performing and non-performing loans assumed by an agency consistent with the Federal Credit Reform Act of 1990 (FCRA) and Office of Management and Budget (OMB) Circular No. A-129 – Policies for Federal Credit Programs and Non-tax Receivables, including:

- Transfer to a subservicer – A federal agency may elect to transfer a loan portfolio to a subservicer that is contracted by the agency to perform servicing actions, including applying loan principal and interest payments, escrowing for taxes and insurance, maintaining collateral files, and completing tax reporting.
- Asset sale (auction) – A federal agency can sell a loan portfolio to a third-party servicer, non-profit, or other governmental entity through a formal process that includes portfolio evaluation and pooling, asset marketing, bid evaluation and sale, and post-sale reporting.
- Securitization – A federal agency can create a funding mechanism for a loan program by selling all or a portion of its interest in a portfolio to a trust. The trust then issues and sells certificates that receive cashflows from the loan collateral pool to investors. Investors receive principal and/or interest payments on the certificates and gain long or short exposure to the asset class.
- Referral to US Treasury – A federal agency can refer loans less than 120 days delinquent to the US Treasury Department's Offset Program in order to offset (or hold back) federal payments due to the borrower[4]. Treasury has broad authority to offset certain benefit payments, federal retirement payments, salaries, vendor payments, and tax refunds due to a borrower in order to recover delinquent debt.
- Write-off – If a federal agency determines that businesses or persons liable for a delinquent loan do not have a current or future ability to repay the debt and the cost of active collection is higher than expected recoveries, it may cease active servicing and write-off the loan as having no value.

The strategies above should not be considered in isolation, but rather as a menu of possible AM&D options that can be tailored to a specific portfolio depending on several factors, including market timing, transaction costs, and portfolio performance.

What's next

Bottom line: As the current economic cycle continues to evolve, utilizing the above AM&D strategies through data-driven and mission centric execution can buttress federal agency responsiveness to primary loan market stress, promote sound federal credit program performance, and

position federal agencies to effectuate positive outcomes for a diverse set of stakeholders.

Asset management and disposition risk considerations

What risks should federal agencies weigh when contemplating AM&D strategies to support federal credit program performance? Some risks include:

- Operational risk – This refers to the risk to federal agency operations from execution of an AM&D strategy, such as a loan sale. A federal agency should understand whether it has the necessary people, processes, technology, and funding in place to plan, implement, and manage an AM&D strategy so it does not adversely impact existing federal credit program operations. An agency should have requisite control of its data to enable effective portfolio reporting to support successful planning, execution, and ongoing management of an AM&D strategy. Furthermore, intra-agency initiatives, such as large IT transformations, that require scarce resources—such as time and people—should be considered when selecting an AM&D strategy as they can affect the quality and availability of loan portfolio data.
- Reputational risk – A federal agency may face reputational risk from faulty execution of an AM&D strategy that damages the perception of the agency in the eyes of stakeholders such as borrowers, lenders, Congress and the US taxpayer. This risk may arise from inadequate planning for an AM&D strategy that does not identify all program stakeholders, understand their needs, and engage them through active solicitation of feedback on program impact. An AM&D strategy should align stakeholder incentives with agency mission to promote positive outcomes for all.
- Liquidity risk – AM&D strategies present the real risk of impairing, instead of supporting, secondary market liquidity for an asset by depressing pricing and market clearing trades in the case of an asset sale. For example, if a bulk asset sale is not timed properly with adequate investor interest or is executed into an illiquid secondary market, it could negatively impact capital formation in the primary market for the asset.
- Financial risk – A federal agency needs to manage the risk of financial loss from implementation of an AM&D strategy. This risk can arise from stress in the primary market from high interest rates that increase loan delinquency, default, and guaranty purchase rates to lenders. For example, if the economics between a federal agency and its subservicer are not aligned, a subservicer may service a portfolio to maturity incurring costs avoidable to the agency if a bulk or flow asset sale in fact represents best execution. Furthermore, high interest rates can result in early amortization (i.e., accelerated payment of principal due to liquidation of underlying collateral) in certificates issued by a securitization trust, which can reduce yields for investors, including a federal agency that owns senior or subordinated notes.

What's next

Bottom line: Federal agencies should consider various risks that accompany adoption of AM&D strategies and manage these risks to promote sound federal credit program performance. Doing so can create avenues to responsibly dispose of performing and non-performing assets in a least cost manner that considers portfolio performance and alignment to agency mission.

Conclusion

In 2024, the economic outlook remains mixed with some cyclical markets currently in recession.. As such, federal agencies are charged with understanding the strategies and risks associated with managing and disposing of performing and non-performing assets. Federal agency executives that take the time to understand and engage in these strategies with an eye toward adoption within existing program operations can better position their loan programs for long-term success through improved performance and stakeholder outcomes.

Contacts

Kevin Lane
Principal | Deloitte Transactions and Business Analytics LLP
kelane@deloitte.com
+1 214 840 1577

Jim Jones
Managing Director | Deloitte & Touche LLP
jimjones@deloitte.com
+1 703 251 1330

Patrick Bennett
Specialist Leader | Deloitte & Touche LLP
pbennett@deloitte.com
+1 571 858 1342

Endnotes

[1] Bureau of Labor Statistics, https://www.bls.gov/opub/ted/2022/consumer-prices-up-9-1-percent-over-the-year-ended-june-2022-largest-increase-in-40-years.htm, assessed January 20, 2024

[2] National Association of Realtors, https://www.nar.realtor/newsroom/existing-home-sales-slid-1-0-in-december, assessed January 20, 2024

[3] US Treasury Department, Bureau of the Fiscal Service, https://www.fiscal.treasury.gov/files/reports-statements/financial-report/2022/notes-to-the-financial-statements4.pdf, assessed January 20, 2024

[4] US Treasury Department, Bureau of the Fiscal Service, https://fiscal.treasury.gov/top/how-top-works.html, assessed January 20, 2024.

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