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The U.S. Loan Sale Market

Executing strategy
Monetizing non-strategic and underperforming assets

While the overall health of the U.S. financial sector has improved significantly since the depths of the combined global financial and economic crises, a number of legacy issues remain. For some institutions, strategy and execution have shifted from crisis to growth. For others, resolving legacy asset quality and underperformance are at the forefront.

Throughout the last six years, loan sales have been a highly popular portfolio management tool used by banks to exit non-core, under-performing and non-performing loan portfolios. During the past two years alone, there have been in excess of 300 loan portfolio sale transactions in the United States.

Going forward, loan sales will likely continue to be a tool used by financial institutions in executing strategy – be it growth, exiting non-core assets or dealing with legacy issues. In the first half of 2014 alone, there were at least 80 loan portfolio transactions aggregating over $24.5 billion.

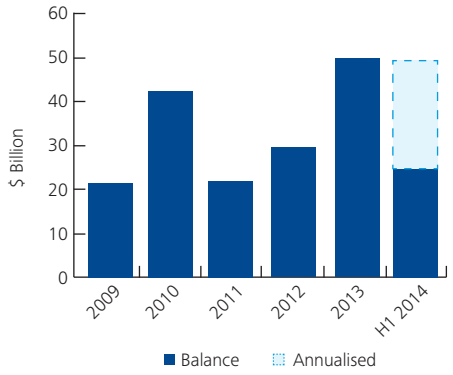
This report will take a look at the U.S. loan portfolio sale market and some insights that can be drawn from transactions that have occurred since 2009. We will then highlight a number of factors that may be important in shaping the loan sale market going forward.

Six years on from the onset of the global financial and economic crises, the U.S. loan portfolio sale market continues to be highly active and liquid.

U.S. loan sale market

From 2009 through the first half of 2014, there were over 900 loan portfolio transactions, totaling over $188.0 billion, driven by a range of sale rationales and involving a broad range of asset types and quality. Figure 1 highlights the trend in transaction volumes from 2009 through H1 2014.

Figure 1: 2009 – H1 2014 loan portfolio transaction volumes

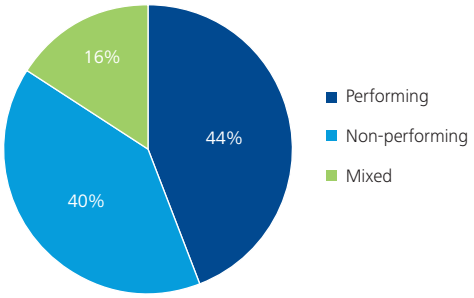


Source: SNL Financial, CRE Direct, Deloitte

Key among the sellers were U.S. money center, regional, and community banks; specialty finance; Government Agencies; CMBS trusts; and foreign banks. Buyers have included a diverse set of U.S. and global strategic investors as well as distressed and opportunistic buyers.

In previous banking crises around the globe, non-performing loans (NPLs) have dominated the portfolio sale market. However, from 2009 through H1 2014, performing loan portfolios made up the largest percentage of the U.S. loan sale market. Figure 2 highlights the asset quality distribution for the $155.0 billion in loan portfolio transactions for which asset quality data was available. As shown, performing loan portfolios accounted for approximately 44% of portfolio transactions as compared to non-performing portfolios at 40% and mixed quality portfolios at 16%. This indicates that financial institutions have accessed the loan portfolio sale market to facilitate the exit of non-core (performing) assets.

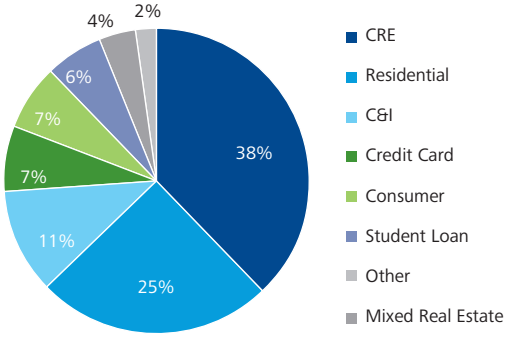
Figure 2: 2009 – H1 2014 loan portfolio transactions – asset quality



Source: SNL Financial, CRE Direct, Deloitte

There was a diverse mix of asset types in the loan portfolio transactions between 2009 and H1 2014. Figure 3 highlights the asset type distribution for the over $187.0 billion in loan portfolio transactions for which asset type data was available.

Figure 3: 2009 – H1 2014 loan portfolio transactions – asset type



Source: SNL Financial, CRE Direct, Deloitte

Commercial real estate loans (CRE) accounted for approximately 38% of total loan portfolio transactions. This is likely attributable to the high-risk weighting ascribed to, and capital required to be held against, commercial real estate lending. Residential loans accounted for a further 25% of portfolio transactions. Within the residential mortgage category, the Department of Housing and Urban Development (HUD) has been a significant seller. HUD has announced that during 2012 and 2013, it sold in excess of $14.0 billion in residential mortgage portfolios and sold an additional $3.9 billion in residential mortgages in Q2 2014. Further loan sales can be expected from HUD as it continues to reduce balance sheet exposure to non-performing loans and improve its overall financial performance.

Shift in strategy

As the U.S. financial sector continues to improve, banks and other financial institutions are increasingly turning their focus from crisis to growth. Along with this shift in strategy, banks are adjusting to increasing regulation, facing higher capital requirements and responding to the call for improved shareholder value.

As a result, capital constraints and the demand for improved return on equity (ROE) play a significant role in institutions' strategic decisions. Key among these decisions is distinguishing between core and non-core areas of focus and the related acquisition or divestment activity to execute the strategy.

Regulatory

The overall health of U.S. banking sector has improved since the depths of the global financial and economic crises in 2009. However, challenges remain as institutions deal with significant changes in the regulatory landscape, including continued stress testing and the ramifications of Basel III.

Through a combination of the Comprehensive Capital Analysis and Review (CCAR) and stress testing under the Dodd-Frank Act, stress testing in the U.S. covers all individual banks, S&Ls and non-bank financial institutions with total assets in excess of $10.0 billion. This includes approximately 235 institutions – an estimated 30 institutions covered under CCAR and an additional 205 institutions covered under Dodd-Frank. The stress-testing under the Dodd-Frank Act also covers non-US banks that have established a bank holding company in the U.S.

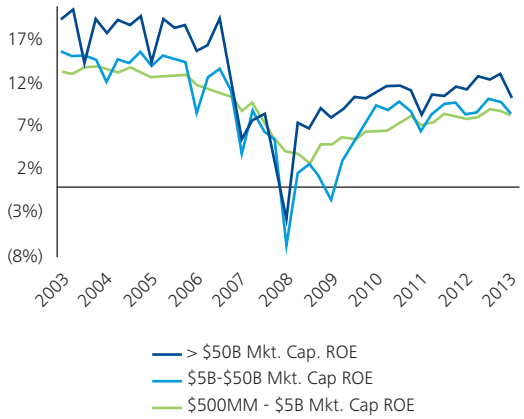
Both CCAR and Dodd-Frank mandate that banks must pass the stress tests in order to avoid regulatory sanctions or restrictions as well as to be able to increase dividend payments and/or share buybacks. One outcome of the continued rounds of stress testing is institutions identifying and divesting non-core and high-risk assets where practical, and in-line with strategy. In so doing, the institutions are working to more effectively manage the capital required to withstand downside stress scenarios.

Banks with less than $10.0 billion in total assets constitute over 90% of all FDIC-insured institutions. While outside the scope of annual CCAR and Dodd-Frank stress-testing, smaller regional and community banks are not immune to regulatory challenges. There have been a number of banks with less than $10.0 billion in total assets accessing the loan sale market as part of their strategy to address regulatory and legacy asset issues. For example, in 2013, Doral, Florida-based Century Bank announced it would sell $90.0 million of non-performing loans in order to clean up its balance sheet. At the time, the bank was "undercapitalized" and under pressure from regulators to raise its capital ratios.

Return on equity

Both stress testing and Basel III place additional requirements on banks with respect to the amount and quality of capital. This in turn has a negative impact on shareholder value as reflected in return on equity. Return on equity in the U.S. banking sector remains below pre-crisis levels. Figure 4 highlights the trend in U.S. banking sector ROE for the years 2003 – 2013.

Figure 4: Historical U.S. bank return on equity



Source: Bloomberg, SNL Financial, Deloitte

As depicted above, average ROE in 2013 for banks in three key market capitalization bandings was significantly less than average ROE for the period 2003 – 2006:

- Market cap in excess of $50.0 billion: 10.2% down from 19.0%
- $5.0 billion to $50.0 billion market cap: 8.5% down from 15.4%
- $500.0 million to $5.0 billion market cap: 8.3% down from 13.9%

It can be interpreted that higher capital requirements – whether required under Basel III or mandated by stress testing – translate into a lower return on equity, all things being equal around net income. Financial institutions are therefore increasingly focused on strategies to meet regulatory requirements, achieve growth and deliver shareholder value. Key areas of focus continue to be balance sheet optimization and capital efficiency with a sharp focus on the reduction of risk-weighted assets. Portfolio sales have been used to help achieve these objectives.

Legacy issues

While the overall health of the U.S. banking sector has improved, a number of legacy issues remain. For example, there continues to be a high level of banks with a CAMELS rating of 3 or higher, as well as a high number of banks under FDIC enforcement actions. Legacy issues remain at the forefront for the impacted institutions and are expected to drive further asset divestment activity.

One measure often used to determine the soundness of a bank is the CAMELS rating – a bank-rating system used by bank supervisory authorities to rate institutions according to six factors: Capital adequacy, Asset quality, Management quality, Earnings, Liquidity and Sensitivity to market risk. Banks with a CAMELS rating of 3, 4, or 5 may be subject to regulatory enforcement actions, enhanced monitoring and limitations on expansion. Further, banks with a 4 or 5 rating are generally considered to be "problem banks" and present an elevated risk of default. Figure 5 highlights that, in 2013, a total of 705 banks (including both U.S. domiciled and foreign-owned, U.S. chartered banks) comprising $8.8 trillion in total assets had a CAMELS rating of 3, 4 or 5. While each bank's situation is unique, each institution will need to focus on resolving specific issues in order to improve ratings and move beyond the legacy issues. Improving asset quality can be addressed through a close examination of the balance sheet and selection of assets for divestment where it makes sense to do so and where the sale can have a positive impact on the institution's overall rating.

Figure 5: 2011 – 2013 CAMELS ratings

CAMEL Rating	No. of Banks	2011 Total Assets ($ Billion)	No. of Banks	2012 Total Assets ($ Billion)	No. of Banks	2013 Total Assets ($ Billion)
3	553	$7,287	497	$8,387	366	$8,578
4	484	$154	343	$128	278	$245
5	82	$22	43	$10	61	$15

Source: SNL Financial

Other indications of legacy issues are enforcement actions issued by the FDIC or another Federal Agency. These may be an indication of financial institution weakness as well as unsafe or unsound practices. In 2013, there were 260 non-personnel-related enforcement actions issued against 216 banks with total assets of $7.0 trillion. Figure 6 details the non-personnel enforcement actions issued between 2011 and 2013.

The enforcement actions are often accompanied by the requirement for a remediation plan. To the extent the plans deal with problematic assets, a detailed portfolio assessment and recovery plan are often required. This may include divestment of legacy, non-performing assets.

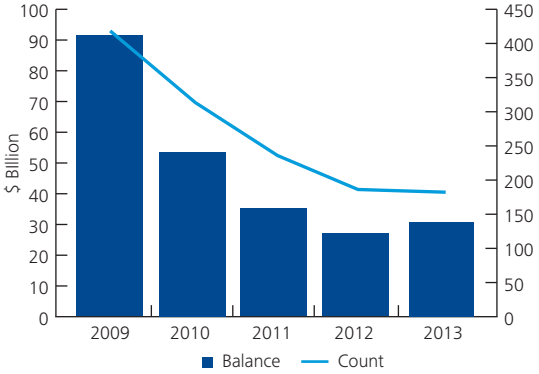
Figure 6: 2011 – 2013 enforcement actions

Action Type	2011	2012	2013
Cease and Desist	134	120	92
Deposit Insurance Threat	10	8	10
Formal Agreement/Consent Order	10	88	38
Hearing Notice or Other Action	24	11	14
Order Requiring Restitution	3	7	7
Other Fines	135	98	87
Prompt Corrective Action	0	10	6
Sanctions Due to HMDA Violation	62	41	6
Total	**378**	**383**	**260**

Source: SNL Financial

A high concentration of CRE lending is another potential risk indicator. More specifically, a CRE lending concentration (loans for non-owner occupied commercial property plus loans for construction, land and land development (CLD)) in excess of 300% of the institution's total risk-based capital indicates an elevated level of risk. Figure 7 highlights that in 2013 CRE lending at over 170 banks exceeded the 300% capital threshold.

Figure 7: Non-owner occupied CRE loans (including CLD) greater than 300% of total risk-based capital

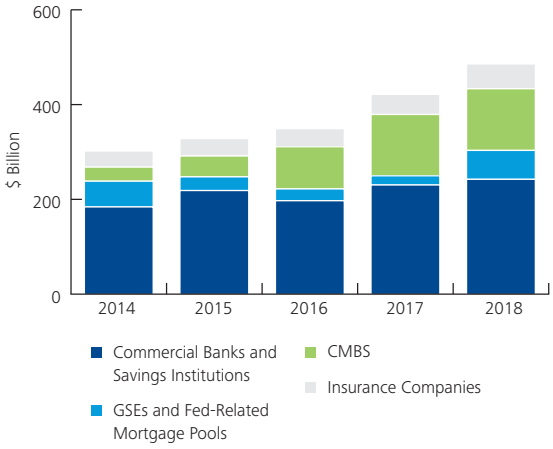


Source: SNL Financial

It is interesting to note that there has been a steady decline in the number of institutions with CRE lending in excess of 300% of total risk-based capital. This is due to at least three factors: banks reducing CRE exposures, consolidation in the banking industry and bank failures. Upon failure, CRE lending exposures are often sold by the FDIC. For example, in April 2014, the FDIC announced the sale of a $206.0 million portfolio of CRE loans from various failed banks.

An additional area of risk in the CRE lending space is the quantum of maturing debt and the exposure to refinancing risk – especially in a potentially rising rate environment. As shown in Figure 8, an estimated $1.7 trillion in CRE loans mature between 2014 and 2018. It is widely speculated that market interest rates could rise over the next 12 – 18 months, as the Federal Reserve continues tapering its bond-buying program. An increase in interest rates could lead to increased defaults and make debt refinancing more difficult. Financial institutions, specialty finance, and CMBS trusts have sight of this impending wall of CRE debt maturities and are examining options to mitigate the risk – including selling CRE lending exposures.

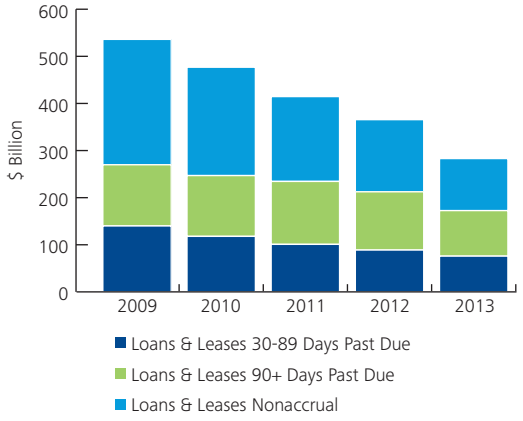
Figure 8: CRE debt maturities



Source: U.S. Department of the Treasury Financial Stability Oversight Council, 2013 Annual Report

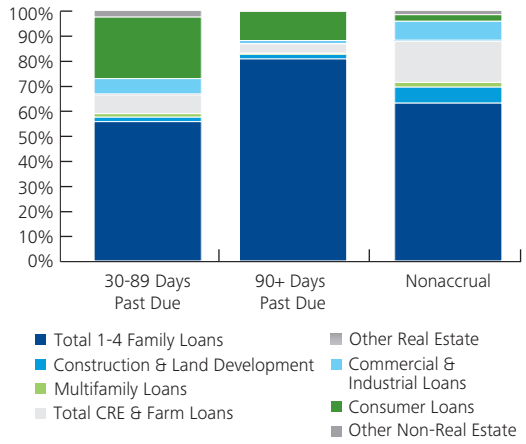
As of December 2013, total past due and non-accrual loans at U.S. commercial banks and savings banks stood at approximately $300.0 billion (see Figure 9). While the level of delinquent loans is down from a 2009 peak of approximately $500.0 billion, a number of banks continue to be challenged with a stubbornly high level of delinquent loans. Figures 9 and 10 highlight the trend in and composition of past due and non-accrual loans, respectively.

Figure 9: Past due and non-accrual loans



Source: SNL Financial

Figure 10: 2013 breakdown of delinquent loans



Source: SNL Financial

European banks

Since the onset of the global financial and economic crises, European banks have been active sellers of U.S. loan portfolios as they have delevered their balance sheets. A primary driver behind this sale activity is the exit from non-core assets in a non-core geography. Among the factors that have made U.S. loan portfolio divestments successful are the recovery of the U.S. market relative to certain European markets, improved asset pricing and deep liquidity in the market.

Sales by European banks have tended to be in response to key events – such as country bailouts (e.g. Ireland), bank-specific bailouts (e.g. Germany and France), and 2011 stress testing – or to a shift in strategy. For example, in 2011, Anglo Irish Bank (subsequently renamed Irish Bank Resolution Corporation which is in liquidation) sold $9.5 billion of performing and non-performing commercial real estate loans as part of its wind down and deleveraging plan.

More recently, in March 2013 HSBC Finance Corporation announced the sale of $3.4 billion of U.S. personal unsecured and homeowner loans. In its announcement, HSBC highlighted the sale as part of its strategy to accelerate the runoff of the legacy consumer mortgage and lending business and a continuation of HSBC's strategy to reposition its U.S. operations and focus on its core businesses.

The currently ongoing round of European bank asset quality reviews (AQR) and stress testing could result in a further round of U.S. asset sales by European banks. The AQR and stress testing is being carried out under the direction of the European Central Bank and encompasses all systemically important banks across the Euro zone ahead of the implementation of an EU-wide, single-bank regulator model. This round of AQR and stress testing is expected to be completed by the end of 2014 and could result in increased provisioning and capital requirements. This in turn could lead many European banks to pursue U.S. asset sales.

Buyers

As previously highlighted, the mix of portfolio transactions has been balanced between performing and stressed/distressed assets. Accordingly, the portfolio buyers have been a mix of strategic and distressed/opportunistic buyers.

In terms of performing loan portfolio transactions, what is non-core to one financial institution may be core to another. As a result, the buyers for quality, performing loan portfolios have been a mix of U.S. money center, regional, and community banks. International banks have also been acquiring U.S. performing loan books. For example, in 2012, a Japanese bank bought RBS' aircraft leasing business for $7.0 billion, and in 2013, Mitsubishi UFJ Financial Group bought $3.7 billion in performing CRE loans from a European bank.

On the distressed side, Preqin reports that distressed private equity fundraising was $32.5 billion in 2013, up from $29.2 billion raised in 2012. The dominant component of capital raised in 2013 was focused on North America ($27.4 billion) as compared to a much smaller figure focused on Europe ($3.1 billion). The North American figure is up significantly from 2012 whereas the European component has dropped significantly. This shift in fundraising reflects a positive outlook on North American distressed investments – including U.S. distressed financial assets.

The level of private equity dry powder increased to $1.05 trillion at December 2013, which is up from $941.0 billion as of December 2012. Of the 2013 figure, approximately $585.0 billion is focused on North America (up from approximately $500.0 billion in 2012) of which $50.0 billion is focused on distressed investments. This increased level of available capital is expected to continue to support increased demand and pricing for distressed bank assets including loan portfolios.

Final thoughts

Over the past five years, the U.S. loan portfolio sale market has been highly active. With over 300 portfolio transactions in the past two years alone, the U.S. loan sale market is the most active market globally.

Domestic banks have been actively selling both performing and non-performing loan portfolios. The balanced mix of asset quality is reflective of a banking sector that has improved overall but continues to deal with remaining legacy issues. In terms of foreign banks, there could be a further round of European bank asset sales following the currently ongoing round of bank AQR and stress testing.

In the first half of 2014, there were at least 80 loan portfolio transactions totaling approximately $24.5 billion, which indicates a continued strong level of transactional volume. As more and more banks shift focus from crisis to growth and others resolve legacy issues, the U.S. loan sale market may continue to be highly active.

In the first half of 2014, there were at least 80 loan portfolio transactions totaling approximately $24.5 billion which indicates a continued strong level of transactional volume.

About Deloitte's Portfolio Lead Advisory Services

Throughout the recent global financial crisis, as well as during previous regional and country-specific financial crises over the past 25 years, members of the Deloitte team have advised governments, financial institutions, and investors in the evaluation and development of strategic options and monetizing of non-core, under-performing, and illiquid financial asset portfolios.

As financial institutions make strategic decisions to address key operating and market challenges, Deloitte can provide a comprehensive suite of services around the identification and exit of non-core and legacy financial asset portfolios. This suite of services includes:

- Design and implementation of structured portfolio wind down and exit programs,
- Development of exit options that maximize value and meet internal divestment objectives, and
- Lead sale advisory on financial asset portfolios identified for sale
- Acquisition advisory in the identification, evaluation and purchase of financial asset portfolios

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