Ch 6 ***Ch 26 Loan Sales ) for facing the credit risks of lending)***

***1-INTRODUCTION***

Traditionally, banks and other FIs have relied on a number of contractual mechanisms to control ***the credit risks of lending***. These have included

(1) Requiring higher interest rate spreads and fees on loans to **more risky borrowers**,

اشتراط فروق أسعار فائدة أعلى ورسوم على القروض للمقترضين الأكثر خطورة

(2) Restricting or rationing loans to more risky borrowers

, تقييد أو ترشيد القروض للمقترضين الأكثر خطورة

(3) Requiring enhanced seniority (collateral) for the bank over the assets of risky borrowers,

(4) Diversifying across different types of risky borrowers, and

(5) Placing more restrictive covenants on risky borrowers’ actions, such as restrictions on the use of proceeds from asset sales, new debt issues, and dividend payments. These traditional mechanisms for controlling or managing *credit risk* were described in Chapters 11 and 12.

This chapter describe the **growing role of loan sales** and **other newer types of techniques** (such as the good bank–bad bank structure) increasingly used by FI managers to control credit risk. While **loan sales** have been in existence for many years, the use of loan sales (by removing existing loans from the balance sheet) is increasingly being recognized as a valuable additional tool in an FI manager’s portfolio of credit risk management techniques (see the Industry Perspectives box).

The chapter begins with an overview of the loan sales market. We **define** and look at **the types of loan sales** and **summarize who are the buyers and sellers of loans**. We then discuss why banks and other FIs would sell loans, as well as the factors that deter and encourage loan sales العوامل التي تردع وتشجع مبيعات القروض. The chapter concludes with a review of the purchase and sale of foreign loans.

***2- THE BANK LOAN SALES MARKET***

**2.1 Definition of a Loan Sale**

Credit derivatives (such as credit swaps مثل مقايضات الائتمان ) discussed in Chapters 23 through 25 allow FIs to reduce credit risk without physically removing assets from their balance sheet.

**Loan sales** allow FIs to reduce credit risk completely by removing the loan from the balance sheet. Specifically, **a bank loan sale** occurs when an FI originates a loan and sells it either 1- with or 2- without recourseبحق الرجوع to an outside buyer.

**If a loan is sold without recourse**, not only is it removed from the FI’s balance sheet but the FI has *no explicit liability if the loan eventually goes bad*. **Panel A** of Table 26–1 shows an FI’s balance sheet **before** and **after** a $20 million **loan sale**.

The buyer (and not the FI that originated the loan) bears all the credit risk. If, however, the loan is sold with recourse, under certain conditions the buyer can put the loan back to the selling FI; therefore, the FI retains a contingent credit risk liability. يحتفظ الوسيط المالي بالتزام مخاطر ائتمان طارئ

**Panel B** of Table 26–1 shows the FI’s balance sheet, including the contingent liability الالتزام المحتمل from the loan sale held off the balance sheet. **In practice**, most loans are sold without recourse because a loan sale is technically removed from the balance sheet only when the buyer has no future credit risk claim on the FI. Importantly, loan sales involve no creation of new types of securities such as the pass-throughs, CMOs, and MBBs described in Chapter 27.

**تعريف ال loan sales**

***As such***, loan sales are ***a primitive form of securitization*** in that loan selling creates a secondary market for loans in which ownership of the loan is simply transferred to the loan buyer.

**التوريق Securitization**

هو بيع الأصول المالية ( قروض ، ذمم ، ديون ........الخ) المملوكة للبنوك أو الشركات إلي وحدات ذات غرض خاص (SPE) لتحويلها من أصول ذات سيولة منخفضة إلي أصول مالية جديدة (سندات ) ذات سيولة مرتفعة قابلة للتداول في أسواق المال بضمان هذه القروض أو الذمم أو الديون وتحمل كوبون ثابت ولها تاريخ إستحقاق محدد

**TABLE 26–1 FI Balance Sheet before and after a $20 Million Loan Sale**

**(in millions**)

**Before Loan Sale After Loan Sale\_\_\_\_**

**Assets Liabilities/Equity Assets Liabilities/Equity**

**Panel A: Loan Sale without Recourse\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_**

Cash assets $ 10 Deposit $ 90 Cash assets $ 10 Deposits $ 90

Loans 70

Loans 90 Equity 10 New investments 20 Equity 10

$100 $100 $100 $100

**Panel B Loan Sale with Recourse**

Cash assets $ 10 Deposit $ 90 Cash assets $ 10 Deposits $ 90

Loans 70

Loans 90 Equity 10 New investments 20 Equity 10

$100 $100 $100 $100

خارج الميزانية: بيع القرض 20 مليون دولار **Off-balance-sheet: Loan sale $20**

**(Contingent liability)**

**Bank loan sale**: Sale of a loan originated by an FI with or without recourse to an outside buyer.

**Recourse:** The ability of a loan buyer to sell the loan back to the originator if it goes bad

**2.2 Types of Loan Sales**

The U.S. loan sales market has *three segments*: **two** involve the sale and trading of

**domestic loans**, while **the third** involves **emerging-market** loan sales and trading.

Since we fully described emerging-market loan sales in Chapter 15 on sovereign

risk, we concentrate on ***the domestic loan sales market here***.

**the domestic loan sales market** may classified into 2 types ,they are :

1. **Traditional Short Term loan sales**

In the traditional short-term segment of the market, FIs sell loans with short maturities, often one to three months. This market has characteristics similar to those of the market for commercial paper issued by corporations in that loan sales have similar maturities and issue size. **Loan sales**, however, usually have **yields** that are 1 to 10 basis points above those of commercial paper of a similar rating. In particular, the loan sales market in which an FI originates and sells a short-term loan of a corporation is a close substitute for the issuance of commercial paper—either directly or through dealers—for the 1,000 or so largest U.S. corporations. ***The key characteristics of the short-term loan sales market are***:

They are secured by assets of the borrowing firm.

They are made to investment grade borrowers or better

They are issued for a short term (90 days or less).

They are have yields closely tied to the commercial paper rate.

They are sold in units of $1 million and up.

Until 1984 and the emergence of the HLT and emerging market loan markets, traditional short-term loan sales dominated the loan sales market. The growth of the commercial paper market (and its accessibility by over 20,000 corporations), as well as the increased ability of banks (through their Section 20 securities affiliates) to underwrite commercial paper (see Chapter 21), also has reduced the importance of this market segment

1. **HLT Loan Sales i.e Highly leveraged transaction (HLT)**

With the growth in M&As and LBOs via highly leveraged transactions (HLTs), especially during the period 1985–89, a new segment in the loan sales market appeared. One measure of the increase in HLTs is that between January 1987 and September 1994, the Loan Pricing Corporation reported 4,122 M&A deals with a combined dollar amount of new-issue HLT loans estimated at $593.5 billion.

***What constitutes an HLT loan has often caused dispute***. However, in October

1989 the **three U.S. federal bank regulators** adopted ***a definition of an HLT loan*** as one that

(1) Involves a buyout الاستحواذ , acquisition, or recapitalization and

(2) Doubles the company’s liabilities and results in a leverage ratio higher than 50 percent, results in **a leverage ratio** higher than 75 percent, or is designated as an HLT by a syndication agent. HLT loans mainly differ according to whether they are nondistressed (bid price exceeds 90 cents per $1 of loans) or distressed (bid price is less than 90 cents per $1 of loans or the borrower is in default).

Virtually all **HLT loans** have the following characteristics:

They are term loans (TLs).

They are secured by assets of the borrowing firm (usually given senior secured

status).

They have a long maturity (often three- to six-year maturities).

They have floating rates tied to LIBOR, the prime rate, or a CD rate (normally

200 to 275 basis points above these rates).

They have strong covenant protection.

*Nevertheless*, **HLTs** tend to be quite heterogeneous غير متجانسة with respect to the size of the issue, the interest payment date, interest indexing, and prepayment features.

**After origination**, some HLT borrowers, such as Macy’s and El Paso Electric, suffered periods of financial distress. As a result, a distinction is usually made between the markets for distressed and nondistressed HLTs. Spreads on HLT loans behave more like investment-grade bonds than like high-yield bonds. A possible reason for this is that HLT loans tend to be more senior in bankruptcy and to have greater collateral backing than do high-yield bonds.

Approximately 100 banks and securities firms make a market in this debt either as brokers or (less commonly) as broker–dealers, including Bear Stearns, CIBC, Prudential Securities, and Goldman Sachs. Most of these FIs view trading in this debt as similar to trading in junk bonds.

**Highly leveraged transaction (HLT) :** A loan made( to sell ) to finance a merger and acquisition: a leveraged buyout الاستحواذ بالرافعة المالية results in a high leverage ratio for the borrower.

**Financial distress: الضائقة المالية محنه ماليه أو**A period when a borrower is unable to meet a payment obligation to lenders and other creditors

***2.3 Types of Loan Sales Contracts***

There are **two basic types of loan sale contracts** or mechanisms by which loans can be transferred between seller and buyer: **participations** and **assignments**. Currently, assignments comprise the bulk of loan sales trading.

***2.3.1 Participations (i.e.* Participation in a loanالمشاركة في القرض**☺

The unique features of ***participations in loans*** are:

* The holder (buyer) is not a party to the underlying credit agreement so that the initial contract between loan seller and borrower remains in place after the sale**. المالك (المشتري) ليس طرفًا في اتفاقية الائتمان الأساسية بحيث يظل العقد الأولي بين بائع القرض والمقترض ساري المفعول بعد البيع.**
* The loan buyer can exercise only partial control over changes in the loan contract’s terms. The holder can vote only on material changes to the loan contract, such as the interest rate or collateral backing. دعم جانبي

The economic implication of these features is that the buyer of the loan participation has a double risk exposure: a risk exposure to the borrower and a risk exposure to the loan selling FI. Specifically, if the selling FI fails, the loan participation bought by an outside party may be characterized as an unsecured obligation of the FI rather than as a true sale if there are grounds for believing that some explicit or implicit recourse existed between the loan seller and the loan buyer. ***Alternatively***, the borrower’s claims against a failed selling FI may be set off against its loans from that FI, reducing the amount of loans outstanding and adversely impacting the buyer of a participation in those loans. As a result of these exposures, the buyer bears a double monitoring cost as well.

**Participation in a loan**: Buying a share in a loan syndication شراء حصة في قرض مشترك with limited, contractual control and rights over the borrower

***2.3.2 Assignments*** نقل الملكية

Because of the monitoring costs and risks involved in participations, loans are sold on an assignment basis in more than 90 percent of the cases on the U.S. domestic market. The key features of *an assignment* are:

* All rights are transferred on sale, meaning the loan buyer now holds a direct claim on the borrower.
* Transfer of U.S. domestic loans is normally associated with a Uniform Commercial Code filing (as proof that a change of ownership has been perfected).

While ownership rights are generally much clearer in a loan sale by **assignment,** frequently contractual terms limit the seller’s scope regarding to whom the loan can be sold. كما هو مبين من الملحوظة التالية

*ملحوظة هامة*

In particular, the **loan contract** may require either the FI agent or the borrower to agree to the sale. The loan contract may also restrict the sale to a certain class of institutions, such as those that meet certain net worth/net asset size conditions. (An FI agent is an FI that distributes interest and principal payments to lenders in loan syndications with multiple lenders.)

**Assignments** are common in loan syndications قروض جماعية, discussed in Chapter 12. In a syndicated loan, two or more banks agree to jointly make a loan to a borrower. The syndicate is formed around the arrangers, which generally include the borrower’s relationship banks, who retain a portion of the loan and look for junior participants (e.g., smaller banks).

**Currently**, the trend appears to be toward loan contracts being originated with very limited assignment restrictions. This is true in both the U.S. domestic and the emerging-market loan sales markets. **The most tradable loans** are those that can be assigned without buyer restrictions. Even so, one has to distinguish between floating-rate and fixed-rate assignment loans. For floating-rate loans, most loan sales by assignment occur on the loan’s repricing date (which may be two or four times a year), due to complexities for the agent FI in calculating and transferring accrued interest—especially given the heterogeneous nature of floating-rate loan indexes such as fed funds plus, T-bond plus, and LIBOR plus. In addition, the nonstandardization of accrued interest payments in fixed-rate loan assignments (trade date, assignment date, coupon payment date) adds complexity and friction to this market. Moreover, while the FI agent may have a full record of the initial owners of the loans, it does not always have an up-to-date record of loan ownership changes and related transfers following trades. This means that great difficulties often occur for the borrower, FI agent, and loan buyer in ensuring that the current holder of the loan receives the interest and principal payments due. Finally, the buyer of the loan often needs to verify the original loan contract and establish the full implications of the purchase regarding the buyer’s rights to collateral if the borrower defaults.

Because of these contractual problems, trading frictions, and costs, some loan sales take as long as three months to complete; reportedly, up to 50 percent eventually fail to be completed at all. In many cases, the incentive to renege on a contract arises because market prices move away from those originally agreed so that the counterparty finds reasons to delay the completion of a loan sale and/or eventually refuses to complete the transaction.

**Assignment:** Buying a share in a loan syndication with (+) some contractual control and rights over the borrower

**Accrued interest** : The loan seller’s claim to part of the next interest payment on the loan

***2.4-Trends in Loan Sales***

Banks and other FIs have sold loans among themselves for over 100 years. In fact, *a large part of correspondent banking involves* ***small banks*** *making loans that are too big for them to hold on their balance sheets—*for lending concentration, risk, or capital adequacy reasons—and selling parts of these loans to large banks with whom they have a long-term deposit-lending correspondent relationship. In turn, *the large banks often sell parts of their loans called participations to smaller banks.*

Even though this market has existed for many years, it grew slowly until the early 1980s, when it entered a period of spectacular growth, largely due to expansion in highly leveraged transaction (HLT) loans to finance leveraged buyouts (LBOs) and mergers and acquisitions (M&As). *Specifically*, the volume of loans sold by U.S. banks grew from less than $20 billion in 1980 to $285 billion in 1989. Between 1990 and 1994 the volume of loan sales fell almost equally dramatically, along with the decline in LBOs and M&As as a result of the credit crunch associated with the 1990–91 recession. In 1994, the volume of loan sales had fallen to approximately $20 billion.

In the late 1990s, the volume of loan sales expanded again, partly due to an expanding economy and a resurgence in M&As. *For example*, the loan market research firm, Loan Pricing Corporation, reported secondary trading volume in 1999 was more than $77 billion. Loan sales continued to grow to over $175 billion in the mid-2000s as FIs sold distressed loans (loans trading below 90 cents on the dollar). Triggered by an economic slowdown, distressed loan sales jumped from 11 percent of total loan sales in 1999 to 35 percent in 2001 and 42 percent in 2002.

As the U.S. economy improved in the early and mid-2000s, the percent of distressed

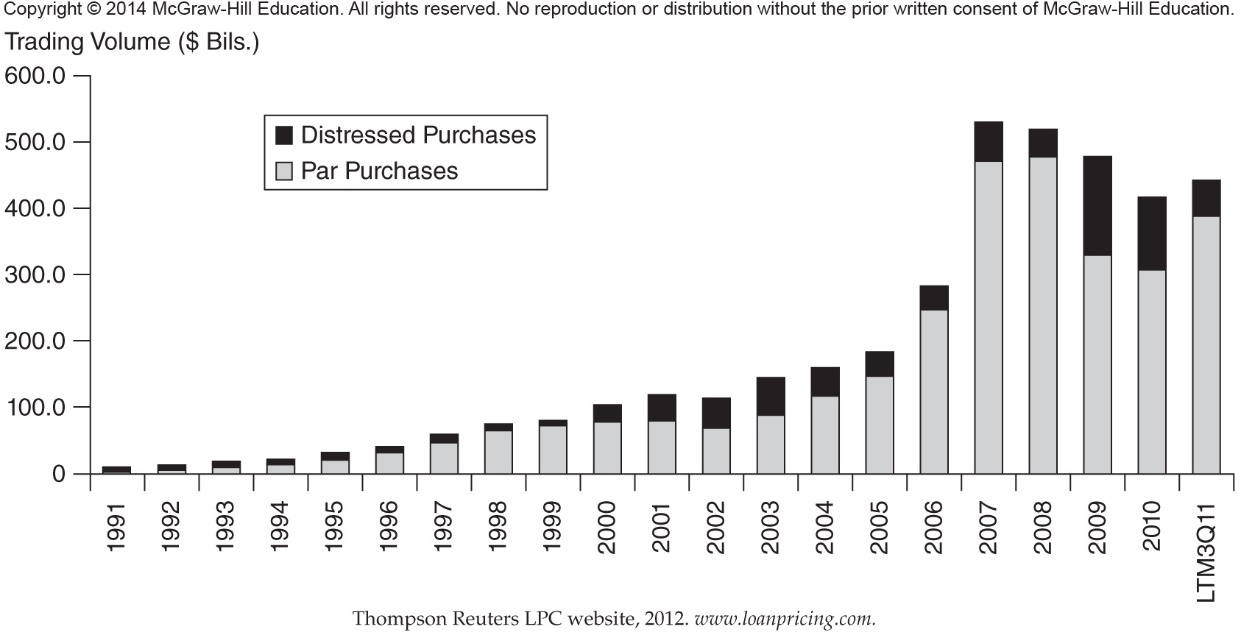
loan sales fell to less than 20 percent. Figure 26–1 shows the growth in loan sales over the 1991–2006 (third quarter) period. Many of these loans are syndicated, involving many sponsoring banks.

***For example***, in 2006 the Loan Pricing Corporation reported that J. P. Morgan Chase was the leading loan syndicator in the worldwide secondary loan market sponsoring 858 deals worth $458 billion. Yet J. P. Morgan Chase retained risk for only $283 billion of these loans. Along with J. P. Morgan Chase, Bank of America ($313 billion), Citigroup ($239 billion), Wachovia ($98 billion), and Credit Suisse ($73 billion) were the top five secondary-market loan syndicators in 2006.

**Correspondent banking:** المراسلات المصرفية: A relationship entered into between a small bank and a big bank **in which the big bank** provides a number of deposit, lending, and other services

**FIGURE 26–1 Recent Trends in the Loan Sales Market, Secondary Loan**

**Volume (1991–3Q2006)**



***2.5 The Buyers and the Sellers of loan sales***

***I -The Buyers***

Of the wide array of potential buyers, some are concerned with only a certain segment of the market for regulatory and strategic reasons. In particular, an increasingly ***specialized group of buyers of distressed HLT loansالقروض المتعثرة*** includes investment banks, hedge funds, and vulture funds.

* **Investment Banks** Investment banks are predominantly buyers of HLT loans because (1) analysis of these loans utilizes investment skills similar to those used in **junk bond** trading and (2) investment banks were often closely associated with the **HLT distressed borrower** in underwriting the original junk bond/HLT deals. As such, large investment banks—for example, CSFB, Merrill Lynch, and Goldman Sachs—are relatively more informed agents in this market, either by acting as market makers or in taking short-term positions on movements in the discount from par.
* **Vulture Funds** Vulture funds are *specialized hedge funds* established to invest in distressed loans, often with **an agenda** that may not *include helping the distressed firm to survive* (see Chapter 5 for a discussion of hedge funds). They include funds run by entrepreneurs such as George Soros and Sam Zell. These investments can be active, especially for those seeking to use the loans purchased for bargaining in a restructuring deal; this generates restructuring returns that strongly favor the loan purchaser. *Alternatively*, such loans may be held as passive investments, such as high-yield securities in a well-diversified portfolio of distressed securities. Many vulture funds are in fact managed by investment banks.

*ملحوظة هامة*

For the *nondistressed HLT market* and the traditional U.S. domestic loan sales market, **the five major buyers** are *other domestic banks*, *foreign banks*, *insurance companies* and *pension funds*, *closed-end bank loan mutual funds*, and *nonfinancial corporations.*

**Vulture fund** : A specialized fund that invests in distressed loans.

* **Other Domestic Banks** Interbank loan sales are at the core of the traditional market and have historically revolved around correspondent banking relationships and regional banking/branching restrictions (such as the McFadden Act of 1927 and the Bank Holding Company Act of 1956 and its 1970 Amendments).

Restrictions on ***nationwide banking*** have often led banks to originate regionally undiversified and borrower-undiversified loan portfolios. Small banks often sell loan participations to their large correspondents to improve regional/borrower diversification and to avoid regulatory-imposed single-borrower loan concentration

ceilings. (Credit exposure to a single borrower should not exceed 10 percent of a bank’s capital.) This arrangement also can work in the other direction, with the larger banks selling participations to smaller banks.

The traditional interbank market, however, has been shrinking. This is due to at least three factors. **First**, the traditional correspondent banking relationship is breaking down in a more competitive and increasingly consolidated banking market. **Second**, concerns about counterparty risk and moral hazard have increased (e.g., Penn Square, a small bank, made bad loan sales to its larger correspondent bank, Continental Illinois, in the early 1980s). **Third**, the barriers to nationwide banking were largely eroded with the passage of the Riegle-Neal Interstate Branching and Efficiency Act of 1994. Nevertheless, some small banks find the loan sales market enormously useful as a way to regionally diversify their loan portfolios.

* **Foreign Banks** Foreign banks remain an important buyer of domestic U.S. loans. In recent years they have purchased over 40 percent of loans sold. Because of the high cost of branching, the loan sales market allows foreign banks to achieve a well diversified domestic U.S. loan portfolio without developing a costly nationwide banking network. However, renewed interest in asset downsizing, especially among Japanese banks (see Chapter 22), has caused this source of demand to contract.
* **Insurance Companies and Pension Funds** Subject to meeting liquidity and quality or investment grade regulatory restrictions, insurance companies (such as Aetna) and pension funds are important buyers of long-term maturity loans.
* **Closed- and Open-End Bank Loan Mutual Funds** *First* established in 1988, these leveraged mutual funds, such as Merrill Lynch Prime Fund, invest in domestic U.S. bank loans. While they purchase loans on the secondary market, such as loan resales, the largest funds also have moved into primary loan syndications because of the attractive fee income available. **That is,** these mutual funds participate in funding loans originated by commercial banks. The mutual fund, in turn, receives a fee or part of the interest payment. Indeed, some money center banks, such as J. P. Morgan Chase, have actively encouraged closed-end fund participation in primary loan syndications.
* **Nonfinancial Corporations** There are some corporations that buy loans, but this activity is limited mostly to the financial services arms of the very largest U.S. and European companies (e.g., GE Capital and ITT Finance) and amounts to *no more than 5 percent of total U.S. domestic loan sales*.

**II- The Sellers**

The sellers of domestic loans and HLT loans are **major money center banks**, foreign banks, investment banks, and the U.S. government and its agencies.

* ***Major Money Center Banks*** Loan selling has been dominated by the largest money center banks. In recent years, market concentration on the loan-selling side has been accentuated by أبرزها *the growth of HLTs* (and the important role major money center banks have played in originating loans in HLT deals) as well as *the growth in real estate loan sales*. In recent years, large money center banks have engaged in large (real estate) loan sales directly or have formalized such sales through the mechanism of a “good bank–bad bank” structure.
* ***Good Bank–Bad Bank*** Bad banks are **special-purpose vehicles** organized to liquidate portfolios of **nonperforming loans** أدوات مخصصة لأغراض معينة لتصفية محافظ القروض المتعثرة. The principal objective in their creation is **to maximize asset values** by separating good loans (in the “good bank”) from bad loans (in the “bad bank”). ***Past examples of bad banks*** include Grant Street National Bank (established by Mellon bank), National Loan Bank (established by Chemical), and National Asset Bank (established by First Interstate). 5 For example, Mellon Bank wrote down the face value of $941 million in real estate loans and sold them to a specially created bad bank subsidiary—Grant Street National Bank—for $577 million. This special-purpose bad bank was funded by bond issues and common and preferred stock. Managers of the bad bank were given equity (junior preferred stock) as an incentive mechanism to generate maximum values in liquidating the loans purchased from Mellon (i.e., achieving a market resale value greater than $577 million).

**Table 26–2** illustrates the sale of nonperforming loans بيع القروض المتعثرة from a good bank to a subsidiary bad bank. **In Panel A** of Table 26–2 , the good bank has $950 million of nonperforming loans along with $2,500 million in performing loans and $500 million in cash assets on its balance sheet before the loan sale. The assets are financed with $2,500 million in deposits, $750 million in purchased funds, and $700 million in equity. If the bad bank, in **Panel B**, buys the nonperforming loans (with the proceeds of a bond, preferred stock, and common stock financing) for $580 million, the good bank gets these loans off of its balance sheet, incurring a $370 million loss in equity (i.e., $950 million face value of loans minus $580 million received in their purchase). The proceeds of the loan sale are then used to pay off purchased funds, bringing their balance down to $170 million, or $750 million minus $580 million. The bad bank now has the $950 million face value loans (for which it paid $580 million) on its balance sheet. These loans can be restructured or disposed of. If the loans realize more than $580 million, additional returns can be passed through to the bad bank common stockholders in dividends or used to repurchase bonds or preferred stock.

***There are at least five reasons for believing that loan sales through a bad bank vehicle will be value enhancing compared to the originating bank itself retaining (and eventually selling) these loans:*** هناك  ***خمسة أسباب على الأقل للاعتقاد بأن مبيعات القروض من خلال وسيلة بنك سيئة ستعزز القيمة مقارنةً بالبنك الأصلي نفسه الذي يحتفظ بهذه القروض (ويبيعها في النهاية)***

1. The bad bank enables bad assets to be managed by loan workout specialists.
2. The good bank’s reputation and access to deposit and funding markets tend to be improved once bad loans are removed from the balance sheet.

3. Because the bad bank does not have any short-term deposits (i.e., is a self-liquidating entity), it can follow an optimal disposition strategy for bad assets,

as it is not overly concerned with liquidity needs.

**TABLE 26–2 Good Bank–Bad Bank Balance Sheets before and after a Loan**

**Sale (in millions)**

**\_ Before Loan Sale After Loan Sale\_\_\_\_\_**

**Assets Liabilities/Equity Assets Liabilities/Equity**

**Panel A: Good Bank\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_**

Cash assets $500 Deposits $2,500 Cash assets $500 Deposits $2,500

Loans Purchased Loans Purchased

Performing 2,500 funds 750 Performing 2,500 funds 170

Nonperforming 950 Equity 700 Nonperforming 0 Equity 330

$3,950 $3,950 $3,000 $3,000

**Panel B: Bad Bank\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_**

Cash assets $ 600 Bonds $ 300 Cash assets $ 20 Bonds $300

Loans 0 Preferred Loans 580 Preferred

stock 100 stock 100

Common Common

stock 200 ------- stock 200

$ 600 $ 600 $600 $600

4. As in the case of Mellon’s bad bank, contracts for managers can be created to

maximize their incentives to generate enhanced values from loan sales.

5.The good bank–bad bank structure reduces information asymmetries about the value of the good bank’s assets (the so-called lemons problem), thus potentially increasing its attractiveness to risk-averse investors.

* **Foreign Banks** To the extent that foreign banks are sellers rather than buyers of loans, these loans come out of branch networks such as Japanese-owned banks in California or through their market-making activities selling loans originated in their home country in U.S. loan sales markets. One of the major market makers in the U.S. loan sales market (especially the HLT market) is the Dutch FI, ING Bank.
* **Investment Banks** Investment banks, such as Bear Stearns, act as loan sellers either as part of their market-making function (selling loans they have originated) or as active traders. Again, these loan sales are generally confined to large HLT transactions.
* **The U.S. Government and Its Agencies** In recent years the U.S. government and its agencies have shown an increased willingness to engage in loan sales. This has been aided by the passage of the 1996 Federal Debt Collection Improvements Act, which authorizes federal agencies to sell delinquent and defaulted loan assets.

Sp = sale price Bv= book value

**TABLE 26–3 FDIC Loan Sales Summary, 1990–2005**

**Percent of Percent of**

**Loan Type Book Value Appraised Value Sales Price Number Sold SP/BV SP/AV**

**1996 Performing vs. Nonperforming Loan Sales**

Performing $ 950 $ 926 $ 910 7,013 95.8% 98.3%

Nonperforming 3,196 563 548 10,099 17.1 97.3

Total 1996 $4,146 $1,489 $1,458 17,112 35.2% 97.9%

**2005 Performing vs. Nonperforming Loan Sales**

Performing $0.5 $0.4 $0.4 2 86. 8% 107.6%

Nonperforming 1.1 0.9 1.0 11 89 .5 108.6

Total 2005 $1.6 $1.3 $1.4 13 88 .7% 108.3%

**Total Performing vs. Nonperforming Loan Sales**

Performing $11,833.5 $10,574.4 $10,882.4 332,592 92.0% 102.9%

Nonperforming 15,225.1 4,356.9 4,504.0 340,340 29.6 103.4

Total 1990–2005 $27,058.6 $14,931.3 $15,386.4 672,932 56.9% 103.1%

**Table 26–3** lists summary *information on FDIC asset sales from 1990 to 2005. Loan sales in 1996 produced the lowest loan sales price to book value, while 2005 resulted in the highest level of sales price to book value for the FDIC*. The Department of Housing and Urban Development also has been an increasingly large seller of mortgage loans on multifamily apartment properties. However, the largest loan sales by a government agency to date were made by the Resolution Trust Corporation (RTC).

Established in 1989, and disbanded at the end of 1995, the RTC had to resolve more than 700 problem savings institutions through merger, closure, or conservatorship. With respect to the U.S. commercial and industrial loan sale market, RTC dispositions had a relatively moderate supply-side effect largely because the bulk of RTC’s asset sales were real estate assets (such as multifamily mortgages). The tendency of the RTC was to combine good and bad loans into loan packages and sell them at auction to bidders. *For example*, in an April 21, 1995, auction, it offered the highest bidder a package of 29 different commercial assets for sale—located in New Jersey, New York, and Pennsylvania—with aggregate estimated market values of $7.5 million. Bidders had only four days to enter bids on this asset package.

***3- WHY BANKS AND OTHER FIs SELL LOANS***

The introduction to this chapter stated that one reason that FIs sell loans is ***to manage their credit risk better***. **Loan sales** remove assets (and credit risk) from the balance sheet and allow an FI to achieve better asset diversification. However, other than credit risk management, ***there are a number of economic and regulatory reasons that encourage FIs to sell loans.*** *These are discussed below.*

**3.1 Reserve Requirements**

Regulatory requirements, such as **non-interest-bearing reserve requirements** **متطلبات الاحتياطي غير المدرة للفائدة** that a bank has to hold at the central bank, are a form of tax that adds to the cost of funding the loan portfolio. Regulatory taxes such as reserve requirements create an incentive for banks to remove loans from the balance sheet by selling them without recourse to outside parties. Such removal allows banks to shrink both their assets and deposits and, thus, the amount of reserves they have to hold against their deposits.

**3.2 Fee Income**

An FI can often report any fee income earned from originating (and then selling) loans as current income, whereas interest earned on direct lending can be accrued (as income) only over time. **As a result**, originating and quickly selling loans can boost يعززأو يزيد أو يقوىan FI’s reported income under current accounting rules.

**3.3 Capital Costs**

Like reserve requirements, the capital adequacy requirements imposed on FIs are **a burden** as long as required capital exceeds the amount the FI believes to be privately beneficial. For tax reasons, **debt** is a cheaper source of funds than equity capital. Thus, FIs struggling to meet a required capital ( K ) to assets ( A ) ratio can boost this ratio by reducing assets ( A ) rather than boosting capital ( K ) (see Chapter 20). One way to downsize or reduce A and boost the K/A ratio is through loan sales.

**3.4 Liquidity Risk**

In addition to credit risk and interest rate risk, holding loans on the balance sheet can increase the overall illiquidity of an FI’s assets. This illiquidity is a problem because FI liabilities tend to be highly liquid. *Asset illiquidity* can expose an FI to harmful liquidity squeezes يعصر - يضغط whenever liability holders unexpectedly liquidate their claims. To mitigate a liquidity problem, an FI’s management can sell some of its loans to outside investors. Thus, **the loan sales market** has created a secondary market in loans that has significantly reduced the illiquidity of FI loans held as assets on the balance sheet.

***4- FACTORS AFFECTING LOAN SALES GROWTH***

**The loan sales market** has gone through a number of up and down phases in recent years (as discussed above). However, notwithstanding the value of loan sales as a credit risk management tool, *there remain a number of factors that will both spur and deter* ستحفز وتعوق نمو السوق وتطوره في السنوات المقبلة the market’s growth and development in future years. We first discuss factors that may deter the market’s growth.

***The factors that may deter the market’s growth of loan sales***

*العوامل التي تمنع أو تعوق نمو السوق لمبيعات القروض*

***4.1 Access to the Commercial Paper Market***

Beginning with the advent of Section 20 subsidiaries in 1987, large banks have enjoyed much greater powers to underwrite commercial paper (and other securities) directly without legal challenges by the securities industry that underwriting by banks is contrary to the Glass-Steagall Act. With the passage of the Financial Services Modernization Act of 1999 and the abolition of the Glass-Steagall Act, the need to underwrite or sell short-term bank loans as an imperfect substitute for commercial paper underwriting is even less important. **In addition**, more and more **smaller middle market firms** are gaining direct access to the commercial paper market. As a result, they have less need to rely on **bank loans** to finance their short-term expenditures.

***4.2 Customer Relationship Effects***

As the financial institutions industry consolidates and expands the range of financial services sold, customer relationships are likely to become even more important than they are today. To the extent that a loan customer (borrower) views the sale of its loan by its FI as an adverse statement about the customer’s value to the FI, loan sales can harm revenues generated by the FI as current and potential future customers take their business elsewhere.

***4.3 Legal Concerns مخاوف قانونية***

A number of legal concerns hamper تعوق the loan sale market’s growth, especially for **distressed HLT** **loans**. In particular, while banks are normally secured creditors, this status may be attacked by other creditors if the firm enters bankruptcy. For example, fraudulent conveyance proceedings have been brought against the secured lenders to Revco, Circle K, Allied Stores, and RJR Nabisco. If such legal moves are upheld, then the sale of loans to a particular party may be found to be illegal. Such legal suits represent one of the factors that have slowed the growth of the distressed loan market. Indeed, in many of the most recent HLT sales, loan buyers have demanded a put option feature that allows them to put the loan back to the seller at the purchase price if a transaction is proved to be fraudulent under the Uniform Fraudulent Conveyance Act.

Further, a second type of distressed firm risk may result if, in the process of a loan workout, the FI lender acts more like an equity owner than an outside debtor. For example, the FI may get involved in the day-to-day running of the firm and make strategic investment and asset sales decisions. This could open up claims that the FI’s loans should be treated like equity rather than secured debt. That is, the FI’s loans may be subordinated in the claims priority ranking.

There are at least six factors that point to an increasing volume of loan sales in the future. These are in addition to the credit risk “hedging” value of loan sales.

**Fraudulent conveyance** : A transaction such as a sale of securities or transference of assets to a particular party that is ruled illegal.

النقل الاحتيالي: معاملة مثل بيع الأوراق المالية أو نقل الأصول إلى طرف معين يعتبر غير قانوني

***4.4 BIS Capital Requirements***

The Bank for International Settlements (BIS) risk-based capital rules and the proposed reforms to those rules (see Chapter 20) mean that bankers will continue to have strong incentives to sell commercial loans to other FIs and investors to downsize their balance sheets and boost bank capital ratios.

***4.5 Market Value Accounting***

The Securities and Exchange Commission and the Financial Accounting Standards Board (FASB) have advocatedدعا أو ايد the replacement of book value accounting with market value accounting for financial services firms (see Chapter 20). In addition, **capital requirements** for interest rate risk and market risk have moved banks toward a market value accounting framework (see Chapter 10). The trend toward the marking to market of assets will make bank loans look more like securities and thus make them easier to sell and/or trade.

***4.6 Asset Brokerage and Loan Trading***

The increased emphasis of large money center banks as well as investment banks on trading and trading income suggests that *significant attention will still be paid to those segments of the loan sales market where price volatility is high and thus potential trading profits can be made*. Most **HLT loans** have floating rates so that their underlying values are in large part insulated from swings in the level of interest rates (unlike fixed-income securities such as Treasury bonds). Nevertheless, the low credit quality of many of these loans and their long maturities create an enhanced potential for credit risk volatility. As a result, a short-term, three-month secured loan to a AAA-rated company is unlikely to show significant future credit risk volatility compared to an eight-year HLT loan to a distressed company. This suggests that trading in loans to below-investment-grade companies will always be attractive for FIs that use their specialized credit monitoring skills as asset traders rather than as asset transformers in participating in the market.

***4.7 Government Loan Sales***

With the passage of the 1996 Federal Debt Collection Improvements Act and the continued downsizing of federal government departments, there is a strong likelihood that the sale of loans by the government and its agencies will increase in the future.

***4.8 Credit Ratings***

There is a growing trend toward the “credit rating” of loans offered for sale. Unlike bonds, a loan credit rating reflects more than the financial soundness of the underlying borrowing corporation. In particular, the value of the underlying collateral can change a loan’s credit rating up to one full category above a standard

bond rating. As more loans are rated, their attractiveness to secondary market buyers is likely to increase.

***4.9 Purchase and Sale of Foreign Bank Loans***

With over $1,200 billion in doubtful and troubled loans on their books in the early 2000s, ***Japanese banks*** presented a huge potential market for the sale of distressed loans. Indeed, a number of commercial banks and investment banks established funds to buy up some of these bad loans. ***For example***, in 2003 Goldman Sachs announced a $9.3 billion fund to buy troubled loans from Japan’s second largest bank, SMFG. This fund represented the first transfer of a bad loan package of this size to a non-government-affiliated entity in Japan. This deal was watched closely as it provided banks with a way of removing bad loans from their balance sheets while still retaining control over the corporate restructuring process.

***5- Summary***

Loan sales provide a primitive alternative to the full securitization of loans through bond packages. In particular, they provide a valuable off-balance-sheet tool to an FI that wishes to manage its credit risk exposure better. The new loan sales market grew rapidly in the 1980s and allowed FIs to sell off short-term and long-term loans of both high and low credit quality. There are a number of important factors that suggest that the loan sales market will continue to grow.