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Using Loan Asset Sales to Improve the Management of Federal Credit Portfolios

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Well-conceived loan asset sales can benefit federal credit programs, especially by showing ways to enhance value through improved credit management. Asset sales can also free scarce staff resources in an age of federal downsizing. Government accounting and budget conventions make it difficult to quantify full financial benefits of asset sales. Finally, loan sales can affect borrowers, federal employees, and other stakeholders, and an effective sales program must address trade-offs between maximizing financial value and serving other public purposes. Strong agency leadership is essential to assure a successful asset sales program.

I. INTRODUCTION

The Financial Management Service of the U.S. Department of the Treasury, in conjunction with the Federal Credit Policy Working Group and the Federal Credit Institute, hosted a Workshop on Promising Practices for Federal Credit Programs October 1-3, 1996. Policymakers and federal credit managers, joined by representatives of government-sponsored enterprises, federal bank and thrift institution regulators, and many others, presented dozens of promising practices.

This report builds upon insights presented at the workshop and the more recent experience of federal agencies, most notably the U.S. Department of Housing and Urban Development, with loan asset sales as a means of valuing and promoting improved management of federal credit portfolios. Conclusions of this review of federal loan asset sales might be stated as follows:

- Past loan asset sales generated an unexpected benefit: The preparation of portfolios for sale gave federal managers important feedback about ways to enhance the management of their programs.
- Today, federal managers again would benefit from the sale of loans as a diagnostic tool. The process of preparing federal credit portfolios for sale can help credit managers to (1) monitor changes in the portfolio that may require management response, (2) keep abreast of developments in the private sector that affect portfolio and program quality, and (3) make informed recommendations to the Congress and other policymakers about cost-effective program improvements.
- Loan asset sales add considerable value because of the rigors of a market test and the way that actual transactions can provide transparency about major financial factors relating to the benefits and costs of a program and opportunities for improved credit management. Some constituencies, however, may not welcome complete transparency. If asset sales are to proceed, issues of transparency must be addressed explicitly.
- Past experience of the federal government shows that

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borrower rights and other public policy goals can be protected in asset sales.

• While loan asset sales can be a superior means of valuing federal credit portfolios and helping to improve federal credit management, there are some obstacles to loan asset sales: (1) Because the government and the private sector keep their books quite differently, loan asset sales may involve a perception of lost value; (2) budget scoring rules today do not encourage loan asset sales; and (3) transaction costs may preclude some asset sales, especially of portfolios that are small or expensive to value.

• In the 1996 Federal Debt Collection Improvements Act, the Congress authorized federal agencies to sell delinquent and defaulted loan assets.[1] Also, the U.S. Small Business Administration recently announced a program of loan asset sales. Otherwise, however, there exists no significant consensus with respect to the wisdom of selling loan assets today.

• Implementation of a program of asset sales at a federal agency can have significant consequences for the distribution of workload (in field offices, for example). Leadership is required to assure that relevant agency staff support rather than fear an asset sales program that affects their role in the agency.

• The major factor that may create a positive climate for loan asset sales is that they can help federal credit agencies to cope with downsizing and today's burdens on scarce staff resources. Sales of loan portfolios can permit the private sector to deal with the mechanics of loan administration while freeing agencies to concentrate upon more important mission-related activities.

• Strong leadership from top agency officials is essential to assure success of an asset sales program and to manage the changes in the agency's business processes that will result. Top leadership needs to create a vision that can be supported by the many external constituencies and internal agency organizations whose immediate interests may be disrupted by such changes.

II. BENEFITS OF LOAN ASSET SALES

A. The Benefits of Improved Loan Valuation

A regular program of asset sales can be the best way to assure the quality of information about the value of federal portfolios, and thereby provide a number of significant benefits. First, a regular process of valuing loan portfolios can provide federal managers with information about areas of potential financial vulnerability. The private credit rating agencies, for example, are experienced at searching out weak financial links in a portfolio. They review a broad range of factors, from loan documentation to servicing to borrower repayment trends. Just as the federal government learned many lessons in the 1980s about loan administration, improved loan valuation promises to be a significant diagnostic device today.

Second, a regular process of loan valuation can help to keep federal credit managers in touch with promising private sector practices. Federal credit managers might learn of developments in inexpensive credit scoring systems, for example, that might provide new information and improve the quality of program management. Loan valuation thus becomes an inexpensive way to benchmark against particular practices of the leading lenders that serve parts of the same credit markets, e.g., small business, housing, or agriculture, as the federal program. Continuing reference to private sector practices is especially important today because of the great progress that private lenders have made in applying new technologies to improve the quality of loan administration and lower the costs.

Third, loan valuation can help federal credit managers to develop information that can be used to support recommendations to the Congress and other policymakers for program improvements. The credit markets change so quickly that federal managers need ongoing access to timely information; a regular process of portfolio valuation can help to provide such information. Evaluation of subportfolios may provide valuable additional information, especially for the larger credit programs.

Portfolio valuation is important, even without the option of asset sales. Federal agencies can prepare loans for sale but not sell them. This saves transaction costs but permits valuation nevertheless. The private credit rating agencies may be of considerable use in a regular process of portfolio valuation.

B. Loan Asset Sales and Portfolio Valuation

Pressures on scarce federal administrative resources mean that some form of privatization may be increasingly desirable for many federal credit programs. Here, the threshold problem is to design privatization well, so that federal managers don't cede control to their private agents.

Asset sales through use of properly designed joint ventures would appear to be easy for a federal credit agency to manage. Less complete privatization, for example, of the servicing function only, may require more federal resources for supervision than do the joint ventures. Use of the private credit rating agencies to value credit portfolios and provide diagnostic services would seem easy to supervise.

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In this context, asset sales would seem to offer a number of advantages. Perhaps most important, asset sales permit a federal credit agency to shift operational burdens onto the private sector, and focus more actively upon implementation of the public purposes of a program. Also, asset sales permit a federal credit agency to impose rigor upon its program information data base. Once a baseline is established, the agency can use asset sales to gain high-quality information about the consequences of changes in a program or its environment.

Asset sales also involve some difficulties that need to be addressed at the beginning of the process. First, the need to develop a market means that high-quality information may not emerge for the first few years. Indeed, early prices are likely to look especially negative, in terms of market prices paid for federal loans.

Second, asset sales may not be useful for smaller programs where the market will tend to discount values, both because of economies of scale and because of the difficulty of generating statistical information about the financial risk of the loans. Also, transaction costs (such as fees for financial advisors and underwriters) are likely to be prohibitive for smaller portfolios. Finally, the experiences of the federal government in the 1980s and of HUD recently show the possible difficulty of building a consensus behind asset sales.

III. LOAN ASSET SALES AS THE IMPETUS FOR IMPROVED MANAGEMENT

A. Federal Loan Asset Sales in the 1980s

Starting in 1987, the federal government adopted a pilot program of loan asset sales. In 1987-1988, federal agencies aggregated federal direct loans into pools and sold them to private investors through some form of securitization. The government conducted a number of public sales of loan pools, including Farmers Home Administration (FmHA) rural development and rural housing loans; Department of Education (ED) college housing loans; Department of Housing and Urban Development (HUD) public facilities loans; multifamily loans and single-family loans; and Department of Veterans Affairs (VA) vendee loans. All these pools were sold without the financial benefit of a government guarantee, and most were sold without recourse.[2]

Although this was not their primary purpose, the sales of loan pools without a government guarantee provided major benefits for federal credit managers as they began to work with their financial advisors to prepare loans for sale. The private credit markets demand considerable information concerning the quality and financial attributes of loan portfolios and asset-backed securities that an issuer offers for sale. Before they were willing to rate the government's asset-backed securities, private credit rating services required loan history data, including accurate and complete loan files. The rating services also needed to be able to evaluate the quality of loan servicing and collections.

As financial advisors began their work, federal managers discovered that their loan record systems could not provide the needed information. Several sales required credit managers to undertake extensive reconstruction of loan portfolio files. In one case, 120 people were assembled to gather, review, and validate loan files and documents to prepare the portfolio for sale.

In the loan sales process, financial advisors identified management improvement opportunities, and federal managers gained knowledge of private sector credit practices. This led to the discovery of (1) poor origination practices and loan record systems that were not capable of providing loan history data; (2) incomplete or missing loan document files with many missing financial statements and legal documents; (3) inadequate servicing and collection procedures, with little or no standardization, especially with respect to policies for curing delinquencies; (4) underreporting of delinquencies due to failure to apply the standard delinquency definition of 30-day past-due payment; and (5) inability of automated systems to handle changing loan data and new legislative requirements as well as inability of many systems to reconcile servicing and reporting data.[3]

The result of these findings was increased emphasis upon improved credit management at a number of agencies.[4] Also, OMB incorporated many of the lessons in a significant revision to Circular A-129.[5]

Loan sales also provided an impetus for federal credit agencies to strengthen their analytic capabilities. The credit rating services assessed credit quality on the basis of factors including loan-to-value ratios, type of property and lien status of the federal government (for collateralized loans), repayment history, size of loan, and loan maturity.[6] As financial advisors and the credit rating services applied their analytic models, federal managers learned important lessons about the factors that they need to monitor and, to the extent permitted by law, control as a way to enhance the value of their portfolios.

In a number of the loan sales, the government imposed special requirements by contract that related to the statutory mandate and public purposes of particular credit programs. Thus, sales of Farmers Home Administration's community program and rural housing loans preserved borrower rights and provided special servicing that would not be available to borrowers in a purely financial transaction.

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Despite the effort to preserve statutory protections for borrowers in asset sales, the Congress became increasingly reluctant to enact the enabling legislation that was required to facilitate new loan sales. At the behest of some authorizing committees, the Congress enacted a number of provisions that created legislative impediments to particular proposed sales. Within the executive branch, and indeed within OMB itself, officials differed as to the benefits and costs of the asset sale pilot program.

B. Federal Loan Asset Sales in the 1990s

1. Lessons from the Experiences of the RTC

The government belatedly recognized and addressed the savings and loan debacle in 1989. Legislation that year created the Resolution Trust Corporation as a temporary federal agency that would reorganize or wind up hundreds of failed thrift institutions, pay off depositors, and sell the recovered assets to private investors.[7] The RTC was a federal corporation with a statutory charter that expired on December 31, 1995. It operated under a mandate to sell assets without a federal guarantee or other recourse to the federal government.

The RTC did a remarkable job. In roughly six years of operation, the agency disposed of assets with a book value of $455 billion, leaving some $8 billion (book value) in its inventory, plus another $6 billion in credit reserves. Recoveries from sales and collections averaged 87% of book value and totaled about $395 billion.[8] The RTC sold most of its assets, including whole loans, through competitive sales; the RTC sold some $42.4 billion of real estate loans as asset-backed securities.

The activities of the RTC are relevant to federal credit agencies on several levels. First, the RTC provides an impressive example of an organization that learned from its experiences and constantly evolved improved processes and programs. Second, the securitization program of the RTC helped to create an entire new market in the private sector for asset-backed securities that are below investment-grade. Third, the RTC used increasingly effective structures for asset disposition that show clearly the trade-offs between sound design and ease of effective implementation. Fourth, the RTC devised joint venture partnerships that provide an excellent model for other agencies.

Thomas Horton, Deputy Director for Asset Disposition at the Federal Deposit Insurance Corporation (FDIC), and formerly a senior RTC official, commented on the RTC's approach:

> "The RTC was clearly a laboratory for experimenting with various asset management and disposition strategies. In fact, we embarked on numerous tracks in an effort to sell the assets and at the same time maximize recovery."[9]

The RTC was able to sell the most marketable mortgage-backed securities and loan assets in bulk sales. For the lower-quality assets, the RTC embarked upon a process of experimentation, beginning with familiar techniques such as contracting out asset management and disposition responsibilities.

Agency officials soon realized that traditional approaches were inadequate to deal with the huge number of difficult assets in RTC hands. They saw how some purchasers made considerable money by securitizing pools of RTC assets, and decided to securitize low-quality assets themselves.

The RTC structured its securitizations to sell equity shares to private investors who would actually dispose of the assets in return for a specified percentage of the cash flows, and also to sell debt obligations based upon the pool of assets. To achieve a high investment grade rating on debt securities backed by pools of nonperforming loans, the RTC establishes a sizable residual reserve fund for each pool.

The purchasers of the equity part of securitized assets found that they could increase their returns by disposing of the assets much more quickly than anyone had expected. This meant that the RTC's asset-backed securities paid off very quickly. Because of the high cost of underwriting and rating securities, securitization seemed expensive for assets that paid off within perhaps two or three years.[10]

RTC officials then experimented with equity partnerships. In 1994 and 1995 transactions, the RTC divided the securities backing a pool of assets into two parts. Private parties bid competitively for the right to manage the pool and received Class "A" securities that entitled them to receive a specified percentage of the cash flows. The RTC retained Class "B" securities for itself and reserved the right to sell these to investors at a later date. In effect, the RTC provided seller financing by keeping a large ownership stake in the pool of assets. The equity partnership thus kept the form of a securitization but altered its substance.

The RTC established fairly rigorous standards for the qualification of bidders, including a performance track record and capital requirements. The winning bidder became the general partner and the holder of a Class "A" certificate that represented a specified (often 49%) equity interest in the partnership. The winning bidder was compensated through its share of returns from the sale of assets or income from the assets and, usually, a servicing fee of 1% of the principal balance of assets remaining in the trust.

The final step in the evolution of the RTC's approaches to asset disposition was the joint venture partnership. The joint venture partnership was designed

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to give the private partner a share of the cash flows from the sale of the assets, but to strip out any other interests of the private partner that could complicate the incentive structure. The partnership agreement precluded payment of a servicing fee and also limited any ability of the private partner to receive tax advantages from the transaction.[11]

The private partner became the general partner with all rights and responsibilities to manage and sell the pool of assets. The RTC was the limited partner, with rights to receive a proportionate share of the cash flows and a proper accounting of all transactions, but essentially in a passive role.

The RTC created some 40 to 45 partnerships to dispose of about $16 billion of assets. It successfully used the joint venture structure to sell a broad range of assets, including real estate and real estate loans, non-performing loans, and even some extremely low-quality assets in the form of judgments, deficiencies, and collections.

As the RTC disposed of its assets, the market began to develop. RTC officials could watch the range of competitive bids narrow as an increasing number of private investors perceived the value of assets that were below investment-grade and sought to purchase RTC assets. Private bidders also began to appreciate the structure of RTC transactions and to bid more competitively on the right to become the equity partner and dispose of RTC pools.

Today, as direct consequence of the RTC's work, the private market has become increasingly efficient at trading so-called "B" and "C" quality, i.e., below-investment grade, residential mortgages. The RTC's work also helped lead to a competitive market for the Department of Housing and Urban Development when it began to sell delinquent and defaulted single-family and multifamily mortgages in the early 1990s.

2. Current Asset Disposition Approaches of the Department of Housing and Urban Development

The Department of Housing and Urban Development provides mortgage insurance for several hundred billion dollars of single-family home mortgages and some $32 billion of mortgage loans that support some 13,300 multifamily apartment properties totalling about 1.9 million units that house some 4 million people.

In the early 1990s, HUD found that the single- and multifamily portfolios both were beset by high default rates compared to the private market. As mortgages defaulted, lenders put them to HUD and claimed payment on their FHA mortgage insurance.

By 1993-1994, HUD held over 2,400 multifamily mortgages with a face value of about $7.5 billion. HUD also held about 90,000 single-family mortgages, worth about $5.5 billion. In an age of federal downsizing, the department found that it could not afford to dedicate the intensive resources that are required to oversee such a large portfolio. As one HUD official observed in 1996:

> "[In addition to significant downsizing that has already occurred] we're scheduled as a department to go to 7,500 which is another 3,000 people off the rolls between now and the end of 1999. What share FHA takes is not something that's been decided. But to the extent that we accomplish that, we need to be able to reengineer the work, not just reengineer the dollars. Every time I sell an asset, a staff person can work on an insured asset..."[12]

The department decided to embark upon a program of asset sales. In early 1994, HUD obtained OMB approval to begin to sell mortgages. In 16 sales during 1995-1996, the department sold a total of 79,000 mortgages, including 1,100 multifamily mortgages and 62,000 single-family mortgages.[13] HUD generally sold its mortgages without FHA mortgage insurance; borrowers who could meet program and underwriting criteria were not precluded from applying *de novo* for such insurance.

The Department of Housing and Urban Development has a complex set of responsibilities when it decides to sell mortgage loans. The RTC successfully separated its mission of maximizing financial returns from non-financial responsibilities such as the provision of low-cost housing for needy home buyers. By contrast, HUD operates under a statutory framework that includes an obligation to provide housing for low-income people as well as the obligation to protect taxpayers by receiving market rate returns when it sells defaulted loans.

The department has made important progress in devising techniques to resolve the tension in its responsibilities. One of the more interesting HUD asset sales involved mortgages on apartment properties that receive rental assistance on less than half of the units. In June 1996, HUD sold a pool of 158 mortgages through an RTC-type equity partnership. HUD issued regulations and included contractual provisions that require the purchasers of the mortgages to keep the current assisted units in use for low income purposes and protect the rights of tenants who receive HUD rental assistance.[14]

The result of this form of asset sale is that a private party becomes contractually obligated to carry out public purposes of the department. Indeed, the contract provides that low-income tenants themselves may bring suit to enforce the low-income provisions. This can help to reduce the burdens on the department that otherwise would be required to oversee the mortgages and properties and their dedication to public purposes.

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IV. STRUCTURING LOAN ASSET SALES

The federal experience with loan asset sales has yielded a number of practical lessons that deserve to be summarized here. A number of useful guides do exist, although they require updating to reflect new developments in the marketplace and new learnings from the RTC and more recent HUD experiences.[15]

A. Federal Experience With the Joint Venture Structure

The experience of the RTC provides some valuable lessons about the trade-off between the government's capacity and the incentives of private parties. HUD has begun to build upon some of those lessons; they are relevant also to the administration of federal credit programs and to possible loan asset sales.

One important lesson from the RTC experience is that sound design of a program or process can greatly reduce the institutional demands upon a federal agency. When the RTC attempted to supervise asset managers in its Standard Asset Management Disposition Agreement (SAMDA) program, for example, it imposed great demands upon the agency's institutional capacity. Moreover, government officials often were tempted to substitute their own judgments for those of the private asset managers.

Sometimes the results could be quite burdensome, as the FDIC's Thomas Horton illustrates:

> "The SAMDA program...I think worked pretty well, but it is highly inefficient. To give you an example, we have a contractor here in Baltimore, Maryland. One of our best contractors. For over five years they had 75 audits. I mean that's just incomprehensible, and there never were any findings with respect to this contractor that I was aware of. But anyway, they had 75 audits." [16]

By contrast, RTC joint venture approaches could be structured to reduce demands upon the government's resources. The RTC entered into contracts with private partners that helped create a win-win outcome: The private partners could make money, but only when they acted to promote the government's interests as well; the RTC's joint venture structures were able to align incentives between the private partners and the government, which reduced the need to oversee and control individual asset managers. The contracts also helped to protect the private partners from long deliberations of government officials who might have been tempted to second-guess any of a myriad of decisions.

The joint venture partnerships provided for risk-sharing between the government and the private party in the form of equity sharing. The winning qualified bidder became the general partner and holder of a specified equity interest in the partnership.

The winning bidder was compensated primarily through its share of returns from the sale of assets or income from assets. The RTC was the limited partner with the right to receive a stated percentage of cash flows. The RTC developed contract terms to prohibit self-dealing and any exceptional tax benefits, which helped to align the interests of the private joint venture partner with those of the government.

While joint venture partnership assured the private partner a significant share of net cash flows, it removed other interests of the private partner that could complicate the incentive structure. The RTC joint venture partnerships were successful financially for the RTC, were easy to monitor, and imposed minimal burdens upon the institutional capacity of the agency.

For example, in two particular joint venture partnerships known as the "AMDA" ("Asset Management and Disposition Agreement") partnerships, the RTC employed three people part-time, amounting to about one full-time equivalent (FTE) person on staff, to oversee some \$3 to \$4 billion of assets.[17] The proceeds from the transactions were used to hire one accounting firm per partnership to monitor that the private partners lived up to the terms of their contractual agreements with the government.

One interesting type of joint venture partnership relates to disposition of judgments, deficiencies, and charge-offs ("JDC" assets). These are very low-quality assets, consisting of receivables that have failed to be collected for a considerable period of time.

In 1993, the RTC began to experiment with the joint venture structure for disposing of these JDC assets. The RTC contributed the assets and became the limited partner. A qualified private partner contributed its asset management and collection services and operating cash, and became the general partner with the right to collect on the assets. The private partner paid all costs of collection except for a few specified items such as audit and organization expenses and approved exceptional collection expenses. The RTC and the private partner split cash flows, usually on a 50/50 basis.

Between 1993 and 1996, the RTC and FDIC used the JDC partnerships to dispose of some 130,000 assets with a book value of about \$10 billion. The private partners so far have worked through about half of the assets and have returned some \$80 million to the government. Ralph Melami, now at the FDIC, reports that officials with experience at the RTC and FDIC consider the program to be very successful; recoveries significantly exceed the estimated five-cents-on-the-dollar that such assets

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usually bring.[18] Moreover, it is far easier to supervise the JDC partnerships than to oversee a more traditional approach of contracting to private parties who would be paid fees for collections.

The RTC, although it was in a different business from that of a federal credit agency, was required to address the same issues of great demands upon a limited institutional capacity. One significant lesson from that experience is that sound design of an asset sales structure can greatly reduce the demands upon the government's supervisory resources.

B. Deciding on a Structure for Asset Sales

Exhibit I presents some of the structures that the government might use to sell loan assets. Other permutations are also possible.

1. Sales of Whole Loans. Sales of whole loans without recourse to the government may be appropriate for those portfolios that are of investment grade, i.e. have a private credit rating of "BBB" or better. These are loans that have solid documentation, good servicing, predictable patterns for their cash flows, and either (1) low default rates or (2) some form of credit enhancement. Few government loan portfolios are likely to meet all these criteria.

2. Structured sales. This approach may be used for lower-quality loan portfolios. Here, the government places the loans into a privately owned trust. The loans thus are treated as private for purposes of servicing and management of the portfolio generally.

Experiences of the RTC and VA indicate that the market tends to underprice-lower quality portfolios. This structure deals with that problem by separating the cash flows from the portfolio into two parts. The government retains a large first loss position in the form of subordinated debt. By taking the subordinated part, the government agrees that the private debtholders will be paid in full before the government receives its share of the cash flows. By retaining a subordinated position, the government can absorb much of the financial risk of the transaction and thus permit sale of the portfolio to private investors. The government retains the option of selling its subordinated security to investors in the below-investment-grade market.

This form of asset sale permits the government to sell a portfolio into the private sector while compensating for the market's tendency to underprice lower-quality assets.[19] By publishing data about losses taken by the subordinated position, the government also can reduce uncertainty and improve pricing of subsequent transactions.

3. Securitization Without Recourse. The government can place the portfolio into a trust and create a joint venture partnership as described above. The private partner purchases a specified equity share, generally less than 49%, and the government holds the rest of the equity. The private partner is the general partner and manager of the assets; the government is the limited partner with a right to receive accounting reports and to assure that the general partner complies with its contractual responsibilities.

One benefit of this structure is that the government holds an equity share. Thus, the government can benefit from gains in the value of the portfolio, perhaps because of improved cash flows that may result from servicing by a private servicer that operates under well-designed incentives.

Perhaps most important for federal credit programs, HUD has refined the joint venture concept to create contractual obligations and incentives for the private partner to serve non-financial purposes as well as achieving financial goals. For HUD, those non-financial purposes involved maintaining the low-income tenancy for a stated percentage of units in the apartment buildings whose mortgages were sold.

Besides selling an equity share in the joint venture, the government either can sell debt obligations to raise money immediately in return for the loan portfolio, or else can hold the debt security itself (i.e., provide a form of seller financing for the transaction). As noted earlier, the RTC found that such joint ventures disposed of assets so quickly that it was not worthwhile to incur the transaction costs needed to sell the debt security.

4. Equity Partnerships. The RTC evolved the equity partnership as a substitute for securitization. The equity partnership offers incentives for effective private management of the portfolio by the private general partner, but avoids the high transaction costs of trying to issue debt obligations.

Except for the differences in funding, because the government does not sell a debt obligation to raise immediate additional cash from the transaction, this option has the advantages of the securitization option. For example, the HUD refinement with respect to serving public purposes also can be implemented through the equity partnership.

In addition, the equity partnership can help an agency to limit the demands upon its scarce in-house resources. One recent example comes from an agency that engages in sales of hard assets rather than loans, the Defense Reutilization and Marketing Service (DRMS) of the Defense Logistics Agency of the U.S. Department of Defense.[20] DRMS has refined the joint venture structure to support a series of transactions, ultimately intended to be a pipeline flow of assets, rather than establishing a new

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Exhibit 1. Alternative Forms of Asset Sales

	Advantages	Disadvantages	Comments
Sales of whole loans	Good for assets that can be valued by investors in a typical due diligence environment; easiest to execute.	The agency retains no ability to participate in improved loan performance; complexities of servicing for public purposes may be more difficult or costly to achieve.	RTC and HUD started with these transactions.
Loan sales - government retains subordinated debt (i.e., takes first losses)	Good when the market would underprice because of inadequate financial data.	Transaction costs can be high; investors often require "AAA" rating on the debt they buy; not user-friendly for the small investor.	Publishing the payment experience on the subordinated debt can improve pricing on later deals.
Securitization - government keeps some equity and sells some equity and possibly debt	Good when the market would underprice because of inadequate financial data; creates a marketable, transferable liquid instrument; government can get cash immediately and also participate in gains, e.g. from improved servicing.	High transaction costs; must maintain credit enhancement; RTC found securities may retire so quickly that securitization doesn't pay.	HUD has refined this structure to serve non-financial public purposes.
Equity partnership	Good for below investment-grade portfolios; government can get cash immediately and also participate in gains, e.g., from improved servicing; easy for the government to monitor (directly and through contractors).	Not user-friendly for the smaller investor; political perception may be that the agency remains involved.	Not as cost-effective for investment-grade portfolios as whole-loan sales.
Governmental securitization - government guarantees all securities	Low transaction costs; avoids perception of low returns; allows privatization of servicing.	Government retains financial exposure and must manage its risk.	This is the Vinnie Mac structure (for VA vendee loans)

joint venture for each new sale. Given the nature of the federal procurement process, such a refinement may offer significant advantages to an agency that intends to conduct a systematic program rather than a series of one-off sales of loan portfolios.

5. *Government Securitization*. This is securitization backed by a full-faith-and-credit guarantee of the federal government that investors will receive timely payment of principal and interest. The leading federal agency to issue such guarantees is Ginnie Mae. The Veterans Administration created a Vinnie Mac program after the Ginnie Mae model, with respect to the VA's vendee home loan program.

Government securitization enables a government agency to privatize many credit management functions. The VA, for example, has used the Vinnie Mac program to privatize the servicing of over 200,000 single-family loans.[21] The major benefit of government securitization is that it avoids (1) the perception of lost value that can be created when the government sells loan portfolios without recourse, and (2) the substantial transaction costs involved in securitization of lower-quality loan portfolios in the private sector. For example, Vinnie Mac securities are sold without an investment advisor,

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without an investment banker to underwrite the securities, and without obtaining a credit rating.

On the other hand, the provision of a full-faith-and-credit guarantee means that the government retains financial exposure to the portfolio for the life of the loans. In effect, this approach allows for privatization of some credit management functions but not for privatization of the financing of the loan portfolio.

C. Selecting a Financial Advisor

One or more financial advisors are essential if a federal agency decides to engage in asset sales.

The Department of Housing and Urban Development successfully used two distinct types of advisor, the program financial advisor (PFA) and the transaction financial advisor.

A program financial advisor can help an agency to prepare for a systematic long term program of asset sales. The PFA can help the agency to decide which portfolios to select for each sale and can help to prepare the market for a series of planned sales. The PFA can help the agency to balance competing issues such as the market's perception of the most attractive portfolios, the requirements of credit budgeting, and the need to address staffing issues of the field offices that hold the loans. The program financial advisor usually is paid a fixed fee for specified tasks or on an hourly basis.

By contrast, the transaction financial advisor helps the agency to sell a particular portfolio of loans for the highest returns available from qualified bidders. The transaction financial advisor usually is paid some fraction of the proceeds of the sale. In addition, the agency needs to hire a due diligence contractor, to prepare loan documentation and conduct optical imaging, and outside legal counsel.

The selection of a financial advisor is very important in determining the success of a loan asset sale. The advisor must have relevant experience, and needs to know the particular investor market and the structures that are likely to elicit the best prices from that market.

Financial advisors are likely to have a repertoire of approaches that they consider most appropriate to apply to particular sales transactions.[22] This tendency to follow past transactions is both a strength and limitation. On the one hand, the financial advisor can help the government agency by building upon its own past lessons; on the other hand, the agency must be able to evaluate the alternative approaches that different advisors may be predisposed to select. As with selection of any private partner, the structure of incentive compensation also can play a role in shaping the options that an advisor considers worthwhile.

The RTC benefitted from a process of interviews with prospective financial advisors. Sandra Thompson, a former RTC official, observes:

> "We really depended on the private sector to partner with us and go through the learning experience with us. We'd say, Here's a portfolio. What is the best disposition strategy? We asked the private sector to come up with seven or eight disposition strategies and give us reasons why, one made sense versus the other."[23]

The RTC also used pilot testing of various approaches:

> "We do net present value calculations. We try to factor in what the expenses were, what the recoveries were going to be. And then we would do pilot programs. We would say, Here's a pilot program. We're trying to implement this program. This works or maybe we should change this. We got a lot of feedback from investors that said, We like this about this specific program or we didn't like this or can you change this. We would take all of these comments into account."[24]

Especially at the beginning, the average federal credit agency may find itself without the background to select the best financial advisor for a particular transaction. While handbooks can be helpful, most federal agencies will initially need more extensive experience with the private markets than is available on-staff.[25]

Federal credit agencies that intend to conduct asset sales would do well to consider tapping the experience of knowledgeable HUD officials and former RTC staffers who remain in the federal government today. They have gained extensive hands-on experience in the selection and supervision of financial advisors and the evaluation of the appropriateness of recommended structures for transactions. It is a matter of some concern that many such experienced officials are leaving the federal government just as the possibility of federal asset sales seems to be increasing.

V. POLICY ISSUES WITH RESPECT TO ASSET SALES

Loan asset sales require a program agency to balance the management benefits of loan asset sales against financial, programmatic and staffing considerations. Fortunately, program agencies can learn from the experience of other federal loan sales. Close coordination with experienced officials at the Office of Management and Budget and the Treasury Department can help program officials to determine whether asset sales might be beneficial and how they might best be structured to balance the policy issues relating to each particular program.

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A. Loan Asset Sales and the Implications of Transparency

Perhaps the most important attribute of loan asset sales relates to transparency: By making terms of the transaction and the pricing explicit, loan asset sales make federal credit programs much more transparent with respect to their benefits and costs.

Enhanced transparency can yield substantial management benefits. Policymakers and managers can become aware of trade-offs, and then devise more effective means of using scarce program and administrative resources to generate the greatest benefits.

In the private sector, investors are willing to purchase loans with higher-than average financial risks, but they will adjust their prices to compensate, and indeed often overcompensate, for such risks. The whole purpose of many federal credit programs is to compensate for the avoidance of risk by the private markets and to offer credit to borrowers who otherwise would not have access.

Supporters of today's approaches to provision of federal credit may fear that asset sales could subject many aspects of today's programs to an intolerable level of transparency. Because information and transparency are not value-neutral, asset sales may provoke some concerns among those who support today's federal credit programs and who may fear disapproval if the full costs are revealed.

B. The Perception of Lost Value and Other Stakeholder Concerns

The perception of lost value presents a major concern to many constituencies considering the impact of loan asset sales. Because the government and private sectors keep their books quite differently, loan asset sales that may be quite cost-effective from a management perspective may give the appearance of lost value. As one government expert observes:

> "It is clear that none of the government's existing accounting or budgetary measures of value are suitable for evaluating the desirability of a proposed asset sale. Thus, it is unlikely that any procedural rule based upon existing budgetary or accounting measures would be capable of distinguishing accurately those asset sales that are harmful to the government's interests from those that are not." [26]

The major difference between government and the private sector is that the government budgets for administrative overhead in a separate account that remains unchanged by an asset sale. By contrast, private bidders take their operating costs into account when pricing a portfolio.

There are other reasons why under the best of circumstances, the government cannot receive close to 100 cents on the dollar for the sale of loan assets. Consider a hypothetical example. Private firms have weighted costs of capital that reflect borrowing costs of debt plus the cost of raising equity. Private firms also must calculate their costs on an after-tax basis. The weighted average cost of capital of a private firm typically may be in the range of 10% to 18%. Assume a conservative 10% discount rate to fund a portfolio in the private sector.

Say that the portfolio includes loans with a face value of $1 million, a borrower interest rate of 7%, maturity of ten years, and defaults that occur in the fifth year for 5% of the loans. The ten-year Treasury rate around the time of the conference in late 1996 was 6.38%, which is used here as the government's discount rate.

Present value analysis shows that the value of this loan portfolio to the government is $968,458. The value of the portfolio to the private investor (assuming a discount rate of 10%) is $825,694, or 14.7% less. Even though the loans may be appropriate for sale, the public perception of the sale of this portfolio of loans would be that the government sold a million dollars of loans for $825,694.[27]

Of course, the whole point of many federal credit programs is to provide preferential funding of loans without regard to profit or to the reluctance of the private market to take risks with less creditworthy borrowers on the basis of less-than-ideal credit information. If asset sales are to succeed, policymakers must accept up front that the loan asset sale by itself is not the cause of the low value of a federal loan portfolio.

On the other hand, some constituencies may have formed expectations, based upon past lenient treatment by the government, that may be disappointed by sales of loan portfolios to private parties. This was HUD's recent experience, for example, when property owners objected both to sales of defaulted HUD-held mortgages and to HUD's effort to use joint venture partners to help manage the department's multifamily mortgage insurance position.

The lesson, both of the asset sales of the 1980s and of HUD's experiences with the multifamily program in the 1990s, is that negotiations with the relevant congressional committees are necessary if asset sales are to become viable as a long-term policy tool. At least for some credit programs, it is likely that negotiations could create a win-win benefit that increases the cost-effectiveness of federal credit programs while protecting the interests of program constituencies.

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C. Alternatives to Asset Sales

A particular agency may determine that asset sales are not appropriate for a particular program. It is then useful to consider alternative means to enhance the quality of program information and provide other management benefits.

One approach to portfolio valuation would be to select a pool of loans and prepare them as if they were to be sold. The government could submit the pool to one or more rating agencies and obtain a rating in some form. The government might monitor the performance of the loans in the selected pool and derive information about their financial performance.

There are a few advantages to this approach. Omitting the step of actually selling loans would save considerable transaction costs. Also, the government would not need to face the uncomfortable prospect of being held responsible for selling loans at a fraction of the face amount.

Disadvantages of forgoing the actual asset sales relate to the rigor that a market test provides. Changes in staff levels or appropriations, for example, could cause termination of an agency's program of evaluating financial information from selected loan pools. Also, without asset sales, agencies may not have an incentive to publish sound financial data. Lack of automatic transparency of financial information may be welcomed by constituencies that benefit from preferential treatment, perhaps because of extensive forbearance policies, that would not look good to a wider audience. Finally, without the rigor that comes from discovering the price of an actual competitive sale, private partners such as financial advisors and credit rating agencies may be left without feedback from the market about the quality of their judgments.

Agencies interested in this approach might consult an earlier report, prepared for the Financial Management Service of the U.S. Department of the Treasury, that explores the possibility of using credit rating agencies to help value federal credit portfolios. That report concludes that this approach is promising and suggests that it would be worthwhile to begin pilot tests with selected federal credit portfolios.[28]

The distinctive competence of the credit rating agencies results from their long years of relevant experience as well as their independence of judgment. These factors would seem to make the credit rating agencies superior to other possible vendors, at least for pilot tests of valuation of federal portfolios. While other financial experts such as accounting firms or academics also have the ability to make sound financial judgments, the credit rating agencies are unusual because of their track record of independence in providing financial information to clients. The essential assumption in this regard is that the government will not change the nature of the performance of the credit rating agencies in the course of hiring their services.[29]

VI. CONCLUSION

There seem to be substantial benefits of instituting regular processes for valuing federal loan portfolios. The benefits of innovation or avoided financial loss in even a small number of instances each year would seem to outweigh the modest costs involved in retaining a private rating service or other source of high-quality information about portfolio values.

In the past, improved portfolio valuation and loan asset sales were considered to be useful but unessential approaches to enhancing federal management of credit portfolios; today, diminished resources make high-quality loan valuation essential for effective management of most credit programs. Continuing reductions in federal program staffs and administrative resources would seem to suggest that loan asset sales may be necessary for some programs as well. With strong leadership asset sales can become the catalyst for substantial improvement in the institutional capacity of federal credit agencies.

END NOTES

[1]31 U.S.C. Section 3711 (1).

[2]A good summary of the financial elements of the 1987 asset sales is found in Danila Girerd, "Loan Asset Sale Update", Issue No. 4, Congressional Budget Office, 1987.

[3]Financial Management Service, U.S. Department of the Treasury, "Improvements in Agency Systems and Procedures Resulting From Loan Asset Sales," draft, prepared by American Management Systems, Inc., for the Credit Administration Division, May 25, 1989.

[4]Office of Management and Budget, "Management for Fiscal Year 1989," "The President's Management Improvement Program," pp. 16-25.

[5]Office of Management and Budget, "Policies for Federal Credit Programs and Non-Tax Receivables," Circular No. A-129 (Revised), January 1993.

[6]Financial Management Service, U.S. Department of the Treasury, "Guide to Conducting Portfolio Sales," (Washington, DC: undated), pp. 5-3 to 5-4.

[7]See, generally, U.S. General Accounting Office, "Financial Audit: Resolution Trust Corporation's 1995 and 1994 Financial Statements," GAO/AIMD-96-123, July 1996.

[8]Resolution Trust Corporation, "Statistical Abstract August 1989/September 1995," Office of Planning Research and Statistics, p. 17.

[9]Statement of Thomas Horton, Deputy Director for Asset Disposition, FDIC, Federal Credit Institute Workshop on Promising Practices, Financial Management Service, US Department of the Treasury, *Proceedings*, October 3, 1996, p. 176.

[10]See Congressional Budget Office, "The RTC's Loan Securitization Process," July 1992. The CBO study provides an excellent overview of

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the advantages and disadvantages of securitization compared to sales of whole loans.

[11]See National Performance Review, "Privatization Through Public-Private Joint Ventures," draft, September 11, 1995.

[12]Helen M. Dunlap, remarks at the Federal Credit Institute's Workshop on Promising Practices for Federal Credit Agencies, October 3, 1996, *Proceedings*, pp. 30-31.

[13]Dunlap, *Proceedings*, pp. 3-46; and U.S. Department of Housing and Urban Development, "Midwest Auction Continues Successful FHA Mortgage sales," HUD No. 96-223, December 20, 1996.

[14]Office of the Assistant Secretary for Housing-Federal Housing Commissioner, "Sale of HUD-Held Multifamily Mortgages," *Federal Register*, Vol. 61, No. 25, February 6, 1996, pp. 4580-4584.

[15]See, e.g., Financial Management Service, U.S. Department of the Treasury, "Guide to Conducting Portfolio Sales," a companion to the Treasury Financial Manual Credit Supplement, undated (about 1990); and American Management Systems, Inc., "Recommendations for Improvements to Federal Credit Operations to Enhance the Loan Asset Sale Process," prepared for the Credit Administration Division, Financial Management Service, U.S. Department of the Treasury, April 25, 1989.

[16]Thomas Horton, remarks at the Federal Credit Institute's Workshop on Promising Practices for Federal Credit Agencies, October 3, 1996, *Proceedings*, pp. 181.

[17]See Cyrus J. Gardner, Roger C. Kormendi, and Gregg M. Breen, "Retained Interest Transactions vs. Bulk Sales: Evidence From the RTC AMDA Partnerships," *The Journal of Financial Engineering*, Vol. 5, No. 2 (1996), pp. 85-116.

[18]Ralph Melami, remarks at the Federal Credit Institute's Workshop on Promising Practices for Federal Credit Agencies, October 3, 1996, *Proceedings*, p. 69.

[19]Another option, favored by the market but more expensive for the government, would be for the government to supply cash reserves in an amount sufficient to qualify the sold debt security for a "AAA" rating.

[20]Information about the DRMS joint venture structure, called the "Proceeds Sharing Sales Transaction," can be found at the DRMS website, www.drms.dla.mil.

[21]Statement of Jim Hass, Loan Sales Specialist, Department of Veterans Affairs, at the Federal Credit Institute Workshop on Promising Practices for Federal Credit Agencies, October 3, 1996, *Proceedings*, p. 51.

[22]The author is grateful to former RTC official Robert I. Dodge III, for this and other insights.

[23]Sandra Thompson, Federal Deposit Insurance Corporation, remarks at the Federal Credit Institute Workshop on Promising Practices for Federal Credit Agencies, October 3, 1996, *Proceedings*, p. 85.

[24]*Ibid.*, p. 86.

[25]See, e.g., Financial Management Service, U.S. Department of the Treasury, "Guide to Conducting Portfolio Sales," a companion to the Treasury Financial Manual Credit Supplement, undated (about 1990).

[26]Marvin Phaup, "Procedural Safeguards and Federal Asset Sales," working paper, December 20, 1995, p. 2.

[27]The author wishes to thank David Burgman of the Risk Assessment and Monitoring Division of the Financial Management Service, U.S. Department of the Treasury, for developing and calculating this example.

[28]HCI, "*Credit Rating Services Study*," prepared for the Financial Management Service, U.S. Department of the Treasury, March 10, 1993.

[29]See Richard Cantor and Frank Packer, "The Credit Rating Industry," *FRBNY Quarterly Review*, Federal Reserve Bank of New York, Summer-Fall 1994, pp. 1-26.

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