

Overview of Debt Sales

By Brian W. Tuite

What to look for in a debt-buying partner.

Many large financial institutions sell distressed assets to a debt-buying partner so they can focus on core business needs and avoid the arduous task of recovering stagnating pools of delinquent and charged-off accounts receivables, especially during this economic downturn.

The top-10 credit card issuers, as well as some super-regional and regional banks, regularly employ debt-selling strategies for their charged-off assets. But most regional and community banks remain unaware of how a relatively easy debt sale can generate a predictable revenue stream. Many banks either don't realize this option is available to them or think it is overly challenging or distracting.

For the more than 8,000 commercial banks in the United States, one of the most difficult barriers to using a debt buyer is the perception that the process is too difficult. Generally, institutions don't know where to start, are overwhelmed at any given time with day-to-day portfolio activities or worry about using valuable time to investigate anything about already charged-off assets.

With additional information, more banks and financial institutions—especially those with large pools of bad assets and uncertainty as to what to do with them—can take advantage of debt-selling opportunities and turn their “red” assets back to black. One of the greatest benefits of choosing to sell those assets to a debt buyer is that the bank or financial institution turns a nonperforming, charged-off asset into immediate revenue and unexpected free cash flow that may then be re-invested into performing assets, thus propelling future revenue growth.

In addition, a sale of distressed assets can:

- bolster a financial institution's bottom line immediately through a cash infusion from the sale of the distressed debt;
- reduce time and staff resources necessary to report on and pursue charged-off accounts; and
- lessen or eliminate reliance on third-party collection agencies.

Ultimately, the best debt-buying partners work in concert with a financial institution's asset management procedures and serve as one member of a three-way partnership—financial institution, collection agency and debt purchaser.

A reputable debt-buying partner should provide:

- time and resources to help a potential client better understand the debt-selling option;
- quick turnaround on pricing and funding and highly competitive bids;
- a single point of contact from business development to make all processes flow smoothly;
- strong asset analysis and modeling capabilities to enable smart decisions about debt purchases;
- a direct contact in client services to work directly with the bank to coordinate the transfers of accounts and data—known as “media”—that follows the purchase of assets;
- staff trained to follow Fair Debt Collection Practices Act guidelines and treat all customers fairly and professionally throughout the asset-recovery process; and
- references and testimonials.

As awareness of debt selling grows, more chief risk officers, lending managers and bank management teams are likely to consider the sale of their written-off accounts.

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Overview of the Asset-Recovery and Management Industry

There are an estimated 1,000 debt-purchasing participants in the domestic accounts receivables industry, according to published industry reports. The largest U.S. debt purchasers typically purchase accounts on a national basis and have their own collection operations, which they may supplement with contingency collection agencies and collection law firms. Other debt purchasers may outsource collection tasks.

Different debt buyers typically focus on various stages of delinquent or charged-off accounts—those bad debts banks and nonbanks charge off as a business expense. Although these accounts are written off at the end of the tax year, they are still legally collectible.

Credit card debt comprises about 70 percent of the accounts sold to debt buyers, with the remainder made up mostly of automobile loans, telecommunications debts, retail accounts, personal loans, utility bills, medical bills and primary and secondary mortgages.

Fresh charged-off accounts are generally 180 to 210 days past due at the time of sale and have not been placed with third-party collectors at the time they are sold. For these reasons, such accounts have a more effective collection cycle than those subject to previous collection attempts by collection agencies.

More Debt-Buying Firms Partner with Attorneys

In the recent recession, charge-off rates have risen significantly, so more charged-off debt is available for purchase. Charged-off consumer receivables, for example, remain at historically high levels as banks and credit card companies charge off their nonperforming accounts and loans.

Charge-off rates in the first quarter of 2010, for example, were 9.95 percent, according to data published by the Federal Reserve. This represents a significant increase from the average charge-off level of four percent for the period of 2005 to 2007.

In fact, according to industry reports, the debt-buying industry experienced a contraction in collections as unemployment rose and consumer confidence weakened. Collection rates have since stabilized but remain at levels well below historical peaks.

As one way to address this collections contraction, the debt-buying industry is recognizing the benefits of pursuing legal collections, particularly in a weak economic environment. For this reason, a number of debt-buying firms are expanding their legal networks.

This expansion makes sense, in part, because laws around the collection of debt change regularly. Also, debt-buying firms working with a network of legal partners can better ensure the recovery process is handled by people who are knowledgeable and up-to-date on the intricacies of the law and the Fair Debt Collection Practices Act.

In addition, attorney partners often find greater success at liquidating the distressed assets than third-party collection agencies. Such a legal network can benefit both consumers and the financial services industry by getting money flowing through the financial system once again.

Debt Sales Result in Immediate Return

In the current economic climate, many financial institutions are warehousing a growing pool of charged-off accounts receivables. These debts likely went through an internal process up until charge-off, when most banks and financial institutions shift their collection efforts to a third-party collection agency.

Third-party collection agencies are typically paid low rates—in the neighborhood of 14 cents to 23 cents on each collected dollar. At this rate of pay, uncollected accounts receivables are much less profitable after four months, and a collection agency isn't likely to put many more resources toward reviving them.

Contrast this approach to selling the charged-off accounts receivables to a debt buyer who stands ready to immediately pay a bank extra liquidation dollars to own the debt. It is the debt buyer's core business to analyze the value of a debt portfolio, purchase the debt and revive the dormant accounts through proprietary technology, specially trained staff and a network of legal partners.

Because a debt buyer owns the accounts outright, it also has a strong incentive to work with account holders over a longer time horizon—up to six years—to identify solutions for repayment and recovery of the assets.

Anatomy of a Distressed Asset Sale

Generally, a bank will provide the debt buyer with a sample file of the types of assets it seeks to sell. The debt purchaser then runs the file through a modeling program to determine the value of the charged-off accounts.

Any bank considering selling a distressed asset portfolio should expect a free evaluation before any sale takes place. The debt buyer's focus will be on purchasing charged-off debts. Assuming the debt buyer believes there is some value to be created, it will submit a bid to purchase the assets.

If the bid is accepted, the bank electronically transfers the full files to the debt purchaser for the purpose of rescrubbing and beginning liquidation. Depending on the individual debt buyer, this will be done either in-house or outsourced, for instance, to a franchise network of legal partners.

To assist in the process, the debt purchaser should have a point of contact in client services to work with someone from the bank—typically a records person—on media documentation. This is because the debt buyer will need copies of the account files—typically billing statements or any statement involved in a commercial or consumer transaction—to aid in the recovery of the debt. Most states require the debt buyer to have such documentation in its possession before contacting a debtor to make arrangements for recovery of assets.

When a bank agrees to sell, it is usually paid the full sum in a matter of days. The bank then has a new source of revenue to invest in short- or long-term needs or redeploy into the marketplace.

Fresher Debt Means a Better Price

The earlier a bank moves to sell its charged-off accounts, the better the price from a debt buyer.

This is because the dollars offered to own the account portfolio vary depending on how many third parties have tried to collect the debt as well as on account demographics and how well the bank is performing.

Financial institutions are finding they can bolster their bottom lines by shortening the debt-placement cycle. They can do this by selling their charged-off accounts to a debt-buying firm immediately after charge-off instead of waiting for a primary collection agency to work the debt for a year. This way, they can get a higher price for the accounts from the debt buyer.

Ideally, a financial institution will enter into a “forward-flow” agreement with a debt buyer. Such agreements are becoming more common and allow banks to sell their charged-off receivables on an ongoing basis.

To further define a debt-selling strategy, consider using a test to determine whether debt selling or traditional collections will have the greatest impact on cash flow and processes. A bank would place equal amounts of debt with its debt buyer and its primary collections agency for a set period of time, say, six months. It would then compare how each approach affects internal processes and staff as well as the advantages and return each delivers over time.

For most banks, the test comes down to the value of money today versus the value of money trickling in over several years. Often, the winner is money in hand today. The debt buyer is essentially putting more cash more quickly into the pocket of the bank.

Debt Buyer's Successful Recovery Opens Door to Revenue Sharing

When a debt buyer is successful in the recovery of assets, a revenue-sharing relationship between the debt buyer and bank is possible on the back end of the process.

The revenue-sharing opportunity presents itself when a debt buyer purchases debt for the right price; can successfully revive the dormant accounts; and, after several years, can pay back additional revenues to the bank. Agreements to

share revenue are not part of a set program but are individually determined at the time a debt portfolio is priced. These options are somewhat rare but often help a seller get more comfortable with the actual sales process.

The revenue-sharing agreement is a strong example of how a debt-selling partnership can provide benefits to financial institutions on several different levels. It also demonstrates how a debt purchaser's aim, ultimately, is to be a true partner alongside a bank's primary collection agency.

Interested in Selling Distressed Assets? Consider These Aspects

In addition to a thorough analysis of how your financial institution can benefit from working with a debt-buying partner, it is important to give the debt-selling strategy these careful considerations:

- **Verify the debt buyer's experience.** Ask detailed questions to understand the company's history and level of industry experience.
- **Confirm the debt buyer also services accounts.** Some debt buyers only purchase the debt and use independent collection agencies to service it. As a best practice, opt for a company that will both buy and service the paper.
- **Determine the best time to introduce the debt buyer into your revenue cycle.** Most financial institutions engage debt buyers when their accounts have reached charged-off status, having gone through an internal collection process.
- **Determine the value and details of your debt.** How many accounts do you have? How old are they? Which ones should you sell to a debt buyer versus those to be collected by an agency?
- **Be willing to open your books and to provide comprehensive information.** The more information you are able to provide a debt buyer, the

more completely the buyer can evaluate your portfolio to provide the best pricing structure. Reputable debt buyers have legally binding practices to protect customer information.

- **Ensure your debt buyer adheres to mandates and regulation such as the Fair Debt Collection Practices Act.** It is imperative your debt buyer adheres to these regulations to ensure customers' rights are preserved. Have the debt buyer sign a business associate agreement prior to sharing account files, or media, with them.
- **Investigate secure communications options provided by your debt buyer.** In addition, investigate the debt buyer's systems and security procedures.
- **Evaluate how much cash flow you require and in what time frame.** The collection process for an account can take months or years. Working with a debt buyer can significantly accelerate cash flow and help you meet your needs sooner rather than later.
- **Determine whether you can repurchase accounts.** Positive customer relationships are key to your business. For your peace of mind, ask a potential debt buyer whether you can repurchase accounts at any time and for any reason, if there is a cap on quantity, if there is a price markup, and if you can exchange for other valid accounts versus paying for them in cash.
- **Ensure the debt buyer operates nationwide or in the regions you require.** In addition to national regulations, many states have specific laws regulating debt collection. Make sure your debt buyer understands and operates within these parameters.

With these considerations in mind, financial institutions of all sizes can gain the advantages of selling charged-off accounts to a debt-buying partner, including recouped losses from unrecovered assets, freed-up capital and the freedom to move on to the most pressing business of the day.

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