

White Paper

Debt sale as a strategic tool – optimising asset value

To get the most out of debt sale, creditors need to move beyond sale as an operational tool for managing bad debt and begin using sale to capture value-creating opportunities across the portfolio.

In the UK, nearly every creditor now uses debt sale. It has become the primary tool for managing increasing volumes of bad debt. Last year nearly £7bn of debt was sold and this year is showing continued growth with an estimated £8bn to be sold.

However, nearly all of these sales are operational, executed to create cash returns from non-performing debt portfolios. Sales are typically executed at specific points in the recoveries process with limited consideration for overall value maximisation. The implementation of Basel 2 and IFRS has increased the economic cost of high risk or highly volatile assets, making sale an increasingly attractive alternative to help optimise the value for a wider range of assets in the portfolio.

As creditors begin to evaluate broader parts of their portfolios seeking opportunities for optimising asset value, there are a number of key activities that need to be considered including: defining the overall objective, completing the right level of analysis, evaluating key metrics to identify opportunities and actually creating value by applying the right sale solution.

Define the Overall Objective

What creates value? There are a number of alternatives ranging from maximising NPV created to generating in-year cash. For semi and non-performing portfolios, value has historically been defined by cash proceeds. However, this approach does not always maximise economic value. For the CFO, a good sale opportunity may even have a lower NPV than continuing to manage the portfolio but is valuable because it helps achieve specific financial targets.

Therefore, a number of factors could be considered, with the ultimate definition of value determined by overall business aims. Key considerations should include:

- net present value of different management or sale options;
- cost to service;
- market value compared to book value (typically based on IFRS provisioning models);
- opportunities to reduce potential future volatility of returns; and
- regulatory capital required for a given asset and the return on this capital

Segment and Complete Analysis

The more granularly the portfolio can be analysed the more opportunities can be identified. However, because the end objective is to identify assets that are appropriate for sale or that should be managed differently, the segmentation must allow for both market pricing and operational execution. The portfolio assets should be sub-divided into segments that are both commercially meaningful and statistically significant.

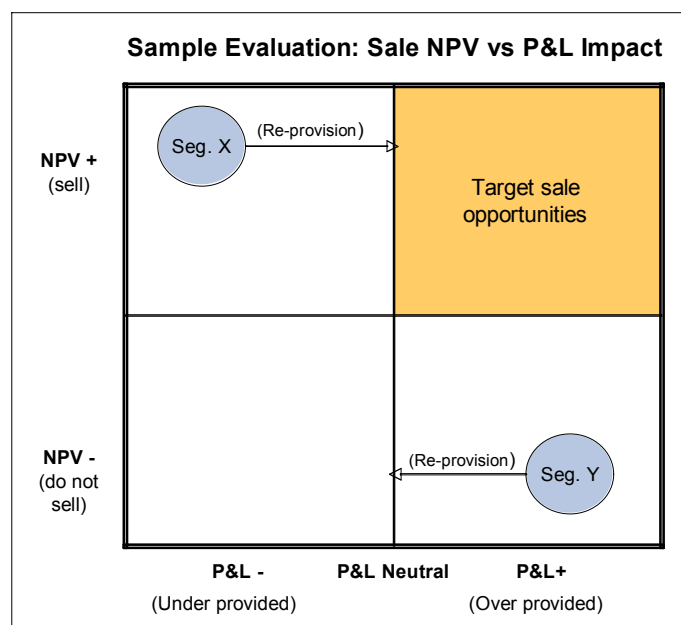
Segmentation for market pricing results in different segments than the traditional product based allocation. Conventionally, balance sheets are segmented along product lines, as this is intuitive from an organisational perspective; however, this is not usually the optimal way to segment a balance sheet to drive up economic value. Commercially meaningful segments are typically based on operational requirements that determine how a servicer would work the segment and what can easily be traded in the market. Access to market data will allow more appropriate segmentation and provide more meaningful market pricing.

Evaluate Key Metrics and Identify Opportunities

Following this analysis, a creditor will have a view on book value, NPV of internal performance, NPV of new servicing options, market price, volatility and the capital required for each segment. These metrics should then be compared in the context of the defined overall objective to determine the most appropriate outcome for each segment.

Some typical evaluations include:

- NPV of existing management compared to book value allows misalignment of the provisioning model to be identified at a segment level;
- NPV achievable from various servicing options and the market price to identify the highest netting treatment;
- segments that are additive or subtractive to return on capital; and
- highly volatile segments where the potential returns of retention do not outweigh the risk of further future losses.



Execute Appropriate Solution

Once the strategy for each segment is selected, the next step is to ensure that all the appropriate future treatments can be accessed. Often the solution will be outright sale, but depending on the overall objective options including securitisation, credit insurance, switching to an external servicer or investment in internal capability may be the more appropriate strategy.

With sale, many creditors have limited the use of this tool to non-performing assets. However, this approach allows value-creating opportunities to be identified across the whole portfolio. For example, a segmented approach could isolate segments within a performing credit card portfolio having high probability of closure in the short term. The economic value of these accounts may well be maximised by an asset sale versus continuing to manage these customers internally as they gradually close their accounts, especially if the customers involved do not fit strategically. Ultimately, creditors can create value by regularly evaluating their portfolio at a more granular segment level and actively comparing to market pricing. Sale then becomes a key strategic tool for managing a wide range of value driving metrics.

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