

White Paper

Resale Key to Long-Term Debt Sale Market

A robust secondary market will accelerate the development of the UK debt sale market and lead to a more stable, mature and professional marketplace

The UK is the world's second largest market for non-performing un-secured consumer debt. Sales this year will reach around £6 billion in face value sold, representing 70% growth from 2005. However, today most transactions are primary sales directly from creditors to purchasers. The volume of debt resold between purchasers represents less than 10% of the total market. This is in sharp contrast to the US where resale represents 40-50% of the debt sold. The emergence of a large secondary market has been an important part of the development of the US market and has supported the entrance of new purchasers, helped improve portfolio returns, provided an effective risk management tool and ultimately enabled higher and more stable pricing for primary sales.

The emergence of an effective secondary market is essential for the continued sustainable growth of debt sale in the UK. We will look at why resale is such a small part of the market today, why creditors should be actively encouraging the development of the secondary market and key considerations for debt purchasers as they develop their resale plans.

Historically, resale in the UK has been restricted in the original sale contract. This restriction is due to concerns around the brand impact of sale and to a broader inexperience with sale as a portfolio management tool. Creditors allowing unrestricted resale are typically those with the most experience with sale, including US based creditors using sale as a tool across all their global portfolios. Most UK creditors insist on complete resale restriction or require the purchaser to request specific permission at the time of sale.

With the growth of the sale market, the emergence of industry groups such as the Debt Buyers and Sellers Group (DBSG), and the increased experience nearly all major UK creditors have with sale, many of the original justifications for limiting resale are being challenged.

An effective secondary market delivers a range of benefits resulting in pricing that is both higher and more stable. This will ultimately encourage creditors to begin to loosen their restrictions on resale. This favourable pricing impact will happen because resale enables the following:

- **Improved market liquidity** – without a secondary market, investing in non-performing assets is a long-term investment strategy. Portfolios typically need to be managed over 4-5 years to achieve target returns, during which much of the investment capital is locked-up and unable to be re-invested. Resale introduces a new liquidation strategy and provides a mechanism for releasing capital earlier providing additional funding to re-invest in new portfolio purchase.
- **Risk management** – while non-performing assets are inherently risky, successful purchasers are those with the experience that allows them to manage this risk. New

purchasers often find it difficult to model this risk. Resale provides a tool to limit potential down-side on any investment and allows for a return from un-serviceable accounts that would normally be valued at zero.

- **Larger overall market size** – resale has the potential to almost double the size of the UK debt market. As the market grows, it becomes possible for investors to invest

larger amount of capital. This will attract new investors and reduce the cost of capital for the larger and established debt purchasers. The larger market will also make niche specialisation more viable, enabling purchasers to further develop capability in managing returns from specific asset classes.

- **New purchasing models** – in the UK, the dominant purchaser business model is buy, hold the debt and service through captive servicing capability. Additionally, we are increasingly seeing the emergence of financial purchasers acquiring portfolios and servicing through available third party servicing solutions. A robust secondary market would enable the emergence of new models such as:
 - Buy, work and resell – Purchasers focused on specific types of activity such as tracing, first-placement, litigation, etc who would buy the debt, manage through their servicing capability and then resell anything not paying.
 - Buy and resell – acquisitions with the intention to break the portfolio into smaller portfolios and resell. In the US, this strategy is based on buying national portfolios and micro-segmenting even down to a county level. With the prevalence of segmentation at the creditor level in the UK, there is potentially less value from this approach than in the US.

Because of these factors, a secondary market would attract more investors and purchasers to the market, decrease the cost of capital, allow these purchasers to pursue increased specialisation and more varied business models, provide for better risk management and improve liquidity to enable shorter cycle time between capital re-investment. Ultimately this would create a more mature market providing creditors with stable pricing reflective of the best achievable returns where the best purchasers are able to succeed through investment in specialisation.

As creditors move to reduce their restrictions on resale, purchasers themselves will need to adapt to having a secondary market. There a number of key challenge purchasers will have to consider:

- On the sell-side, the three main challenges will be knowing when and what to sell, managing the information sharing required as part of the due diligence process, and ensuring the contracts and post-sale management processes link to the original sale contracts. The first two areas require a shift in mentality as purchasers evaluate how resale can fit into their overall strategy. This process will be similar to the one typically followed by creditors first looking to sell and is largely one of education around why another purchaser can achieve returns on something that cannot be managed internally and why sharing the right level of data is critical to maximising value.
- On the buy-side, many of the companies who would likely be secondary purchasers are not buying today. This will increasingly be collection agencies and solicitors who will need to gain access to investment capital and align their process behind managing owned debt. There will also need to be a mentality shift around understanding why a purchaser might be selling a portion of their portfolio vs. continuing to work it.

For both creditors and purchasers, the development of the secondary market will require a change in mentality and approach to sale. Creditors will need to consider the best mechanisms for managing both the potential brand risk of poor secondary purchaser selection and post-sale

management requirements. Purchasers need to understand how to evaluate the value of resale and determine an effective mechanism for sharing the data needed to sell with potential competitors.

These are the dynamics that will need to be managed as debt sale begins to transform more into a marketplace. Many of these are already starting to emerge with the existence of brokers

in the UK market. Brokers helped support the growth of the US secondary market by providing an arms-length engagement model for purchasers to complete sales, but because of their small scale and inability to interact with creditors, they have been unable to address creditors' long-term brand concerns as portfolios have continued to be resold. The UK is a different market and has active full service brokers such as TDX Group and as such the market can gain the benefits of resale while learning from the US to address creditor concerns.

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Published in Credit Management, October 2006

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