

# ADB Virtual Training Course on NPL Resolution for IPAF Members and DMC Officials

## Session 2: Supervisory Rules and Regulation (Global and Regional Best Practices) **Responses to Questions**

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## Clarification on size distribution of U.S. banks

**The top 4 banks in the U.S. (JP Morgan Chase, Bank of America, Wells Fargo, and Citibank) have 44 percent of the total assets of the system.**

**The top 20 banks have 67 percent of the total assets.**

**The top 50 banks have 80 percent of the total assets.**

**The top 100 banks have 86 percent of the total assets.**

***In summary, we may say that the U.S. banking system is relatively unconcentrated.***

***The total assets of the 5,001 banks in the system are \$21.9 trillion.***

## More information on asset exchanges

### ***Example of a flawed asset exchange (from a Federal Reserve letter to banks, Feb. 2021)***

#### *Example of an asset exchange*

An asset exchange marketer may approach an institution that has a high level of problem assets. The transaction proposal might offer a 4-to-1 or even 5-to-1 ratio asset exchange. Usually the selling institution has to advance cash roughly to equalize the values of the assets ceded and the assets received.

In a specific case, the selling institution gave up \$7 million of problem assets plus \$20 million in cash in exchange for \$27 million in purported fair value of performing home equity lines of credit (HELOCs). The deal contained a put-back provision, in which the marketing company would buy back at par HELOCs that were 60 days past due, up to a specified limit and subject to a 36-month limitation to exercise this option. The marketing company established a put-back reserve equal to the specified limit, with a level ranging between 5-7% of the HELOCs' purported fair value. The put-back funds were placed in a depository account with the selling institution, which reduced the counterparty credit exposure.

#### *Risk management concerns*

The selling institution deemed the new assets to be a good investment since they were seasoned and current at the time of acquisition and/or the borrowers had high credit scores. However, it turned out that the pools acquired were “survivor pools” that had been carved out from a larger population of loans and whose seemingly good performance might not be indicative of future performance. Reportedly, the institution also overemphasized the high credit scores and performance history of the acquired loans, to the detriment of other measures of risk.

# More information on asset exchanges

## ***Example of a flawed asset exchange (from a Federal Reserve letter to banks, Feb. 2021)***

As part of its due diligence, the selling institution's management relied on a third-party valuation report to support the economic merits of the transaction and the value of the assets acquired. However, management did not closely review key valuation assumptions, which were provided by the marketing agent and were unduly optimistic. As a result, the acquired assets' values were significantly overstated. The key weaknesses that resulted in an inaccurate valuation included:

- Not determining fair value based on key assumptions that market participants would use in valuing the assets. Most notably, management did not consider a risk adjustment to reflect the risk premium that market participants would demand as compensation for bearing any uncertainty inherent in the cash flows of the assets.
  - Unsupportable default probabilities based upon current market data and loss history.
  - Mapping the default probability to a single-issuer corporate bond matrix, which had little correlation with a pool of multiple-obligor consumer debt.
  - Reliance on origination loan-to-value (LTV) ratios with no consideration of the current LTV ratios. Some estimates placed LTV ratios at the time of the asset exchange transaction at well above 120%.
  - Assuming a loss severity of 67% for a HELOC portfolio, where a 100% loss rate would be more appropriate.
  - Lack of understanding of the first mortgages associated with these HELOCs and their risk characteristics.
  - Unreliable and stale information on prepayment speed. In some cases, the prepayment speeds were miscalculated by the third-party fair value provider.
  - Truncated cash flow modeling timeframe due to use of unrealistic assumptions, such as prepayment speed, that went into determining the performing assets' weighted average life.
- The result was that the fair value was overstated and the institution incurred significant losses.

## More information on asset exchanges

### ***Another generic example of an asset exchange, from a bank's annual report (Form 10-K) to the Securities and Exchange Commission (2009)***

***Loans Held For Sale.*** On February 5, 2009, EOS and Aurora Bank entered into an Asset Exchange Agreement (the “February Asset Exchange”) pursuant to which we agreed to transfer loans secured primarily by commercial real estate and multi-family residential real estate in exchange for loans secured primarily by residential real estate. As a result of entering into the February Asset Exchange, we reclassified all of our loan assets as held for sale, recorded a fair value adjustment, and reported these loans at the lower of their accreted cost or market value.

On July 20, 2009, EOS and Aurora Bank mutually agreed to terminate the February Asset Exchange following the OTS failing to grant Aurora Bank’s requests for non-objection with respect to the February Asset Exchange. We continue to carry these loan assets at the lower of their accreted cost or market value. Prior to February 5, 2009, our loan assets were considered held for investment and recorded at accreted cost. Effective November 18, 2009, EOS and Aurora Bank entered into and consummated an Asset Exchange Agreement (the “November Asset Exchange”) pursuant to which Aurora Bank agreed to assign various single family residential mortgage loans to EOS in exchange for EOS assigning certain commercial and multi-family mortgage loans to Aurora Bank. From the November Asset Exchange, we received residential mortgage loans, including jumbo mortgage loans, in exchange for commercial and multi-family loans transferred to Aurora Bank. The residential mortgage loans received were recorded at their fair value and currently are presented at fair value.

# Programs to support bank borrowers in the U.S. under COVID-19 conditions

## The Paycheck Protection Program for Small Businesses

- A program of lending to small businesses with guarantees by the Small Business Administration
- Open to SMEs with fewer than 300 employees (formerly 500 in initial phase)
- Can be used to help fund payroll costs, including benefits. Funds can also be used to pay for mortgage interest, rent, utilities, worker protection costs related to COVID-19, uninsured property damage costs caused by looting or vandalism during 2020, and certain supplier costs and expenses for operations.
- Loan will be forgiven if proceeds are used to cover payroll costs, most mortgage interest, rent, and utility costs over the specified period after the loan is made, *and* if employee and compensation levels are maintained. Payroll costs are capped at \$100,000 on an annualized basis for each employee, and at least 60 percent of the forgiven amount must have been used for payroll (lowered from the original 75 percent requirement).
- **Funding available until 31 May 2021**
- **Has so far distributed \$780b in loans to nearly 11m borrowers**

# Programs to support bank borrowers in the U.S. under COVID-19 conditions

## The Main Street Lending Program for Larger Businesses

- Open to business with up to 15,000 employees or up to \$5 billion in annual revenue
- Open to non-profits such as hospitals, schools, and social service organizations with at least 10 employees and endowments of no more than \$3 billion
- Five-year loans
- Loans made by banks and then sold to the Fed, with the banks retaining 5 percent share
- **Program was not considered a success because of lack of uptake – only \$17.5b distributed, 3 percent of capacity**
- **Banks didn't feel adequately compensated to take on the riskiest borrowers**
- **For medium and low-risk borrowers, banks just continued with their standard lending programs**
- **Closed down on 8 January 2021**

Home mortgage borrowers with federally-guaranteed loans were given payment holidays of 180 days, with a further 180 days if necessary. There is a moratorium on foreclosures that could possibly be extended to January 2022. Term of loan could be extended by up to 40 years!

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