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Why aren’t banks selling problem loans?

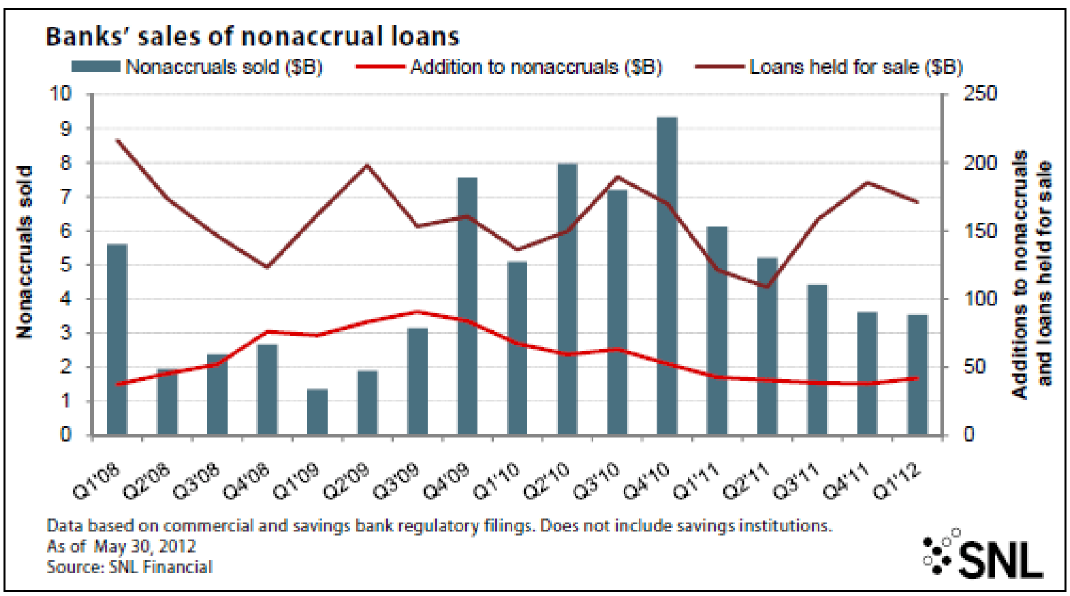
By Tahir Ali and Nathan Stovall

Even though inflows of problem loans remain elevated, sales of distressed assets continued to slow in the first quarter as banks lacked the capital and willingness to offload product.

Sales of distressed assets slowed considerably in 2011 along with a slowdown in bank capital raising activity. Sales activity slowed even more in the first quarter despite a steady inflow of nonaccruals in the period, resulting in nonaccrual loans rising in the first quarter after eight straight quarters of declines.

There are more interested buyers of distressed product now than a few years ago, and most banks want to move beyond their credit problems, but doing so requires the capital capacity and willingness to take a loss when the sale occurs, according to presenters on a May 31 webinar titled "Purging Distressed Loans: A Strategic Approach" hosted by SNL.

SNL asked listeners on the webinar whether they thought the market for distressed assets was more open than a year ago and the majority of responders — roughly 57% — believed that the market was healthier now than in the recent past. One of the webinar presenters, Mark Thompson, senior vice president and head of special assets at CenterState Banks Inc. unit CenterState Bank of Florida NA, said the answer to that question depends on whether you are talking about investor appetite for distressed product or banks' desire and willingness to sell.



"If you're talking about from the standpoint of are there willing buyers out there to purchase these assets? I think, absolutely, hands down that market is bigger than it was and continues to grow daily," Thompson said on the webinar. "The banks aren't putting the product out there to sell. Why in the world would they not? The reason is capital constraints. Can banks take the loss?"

Thompson said CenterState was able to absorb losses when it sold assets in part because it recorded a sizable bargain purchase gain associated with a failed bank deal that allowed it to mitigate the loss.

Many bankers claim they have marked distressed assets near a market price, but that seems unlikely given the hits most banks take when selling distressed product. More than 75% of the audience polled during the SNL webinar thought that banks could not sell distressed product without taking significant hits.

Jon Winick, president of Clark Street Capital, said that if banks carried nonperforming assets at true market values, they simply would not have any since managing NPAs is an expensive proposition. Determining the actual cost of holding onto problem assets is difficult, but Winick said that Clark Street has found that it can cost a bank as much as 20 cents for every dollar of NPAs.

"There's no incentive to carry a high level of NPAs," Winick said on the webinar. "I would estimate banks are probably in the third inning of resolving problem assets."

Many hoped that banks would be further along in the process by now, particularly since institutions began purging their balance sheets in force not long after the industry was recapitalized during the second half of 2009 and the early part of 2010. The lack of capital in 2008 and for most of 2009 led to nonaccrual asset sales of just $12.61 billion in 2008 and $13.97 billion in 2009, the year nonaccrual loans peaked, according to SNL data.

After being recapitalized, many banks used some of the fresh capital to help absorb losses when selling distressed assets. Banks' sales of nonaccrual assets jumped in 2010 to $29.62 billion, more than 2008 and 2009 combined, culminating with $9.35 billion in sales in the fourth quarter, according to SNL data.

Selling activity dropped considerably in 2011, after investment sentiment toward banks soured and capital raising became more difficult. Nonaccrual sales totaled $19.37 billion in 2011, with just $3.61 billion in sales in the fourth quarter.

The pace of nonaccrual sales was even weaker in the first quarter of 2012, falling to $3.54 billion. The weaker sales activity occurred even though inflows of nonaccruals actually increased, rising to $41.88 billion from $37.77 billion in the fourth quarter.

Largest sellers of nonaccrual assets in Q1'12

Company (ticker)	Nonaccrual assets sold ($M)	Additions to nonaccrual assets ($M)	Total nonaccrual assets ($M)	Total assets ($M)
Citigroup Inc. (C)	444.0	5,182.0	12,935.0	1,944,423.0
JPMorgan Chase & Co. (JPM)	278.0	7,228.0	23,494.0	2,320,330.0
Ally Financial Inc.	277.0	1,172.0	3,839.0	186,350.0
Wells Fargo & Co. (WFC)	249.0	5,903.0	22,159.0	1,333,799.0
SunTrust Banks Inc. (STI)	240.1	647.3	2,708.4	178,256.2
U.S. Bancorp (USB)	209.0	614.0	2,831.0	340,762.0
BB&T Corp. (BBT)	181.3	737.2	1,843.2	174,751.9
Bank of America Corp. (BAC)	180.6	5,821.3	28,736.8	2,180,055.7
Regions Financial Corp. (RF)	151.1	547.5	2,399.7	128,281.8
CIT Group Inc. (CIT)	118.7	95.2	481.9	44,148.7
Santander Holdings USA Inc.	98.7	259.2	1,249.6	82,891.1
Synovus Financial Corp. (SNV)	60.4	139.6	854.4	27,064.8
RBS Citizens Financial Group Inc.	58.2	394.0	1,552.7	129,963.6
PrivateBancorp Inc. (PVTB)	56.2	74.9	256.1	12,623.2
Zions BanCorp. (ZION)	53.7	205.1	1,016.9	52,898.4
BMO Financial Corp.	52.7	668.3	1,726.6	117,450.9
HSBC North America Holdings Inc.	48.6	1,867.6	8,504.6	340,342.5
Washington Federal Inc. (WAFD)	39.3	39.0	204.5	13,564.1
Bank of New York Mellon Corp. (BK)	39.0	213.0	689.0	300,197.0
BBVA USA Bancshares Inc.	37.3	216.6	1,368.0	65,390.6

All nonaccrual asset figures displayed may include assets guaranteed by the U.S. government.
Limited to top-tier consolidated bank holding companies and thrift holding companies, based on regulatory data reported in Forms Y-9.
Data current as of May 30, 2012
Source: SNL Financial

Larger banks remain the most significant sellers of problem loans in terms of overall dollar figures. Not surprisingly though, the most active sellers in the group were the ones with the most capital. Among the top 20 sellers, Santander Holdings USA Inc., PrivateBancorp Inc. and Washington Federal Inc. purged their nonaccrual assets the most, selling 24.64%, 21.96% and 19.23% of their nonaccrual assets, respectively, in the first quarter. Santander and Private Bancorp reported tangible common equity ratios of 11.53% and 7.69%, while Washington Federal Inc. unit Washington Federal reported a tangible common equity of 12.19% in the first quarter.

Those banks with capital that have taken an aggressive approach to asset dispositions and purged their balance sheets have benefited. Winick's firm Clark Street conducted a study on banks that had engaged in bulk sales of problem assets between the fourth quarter of 2009 and the end of the third quarter of 2011 and found that the stocks of those institutions had easily outperformed peers. Clark Street looked at a sample of 15 banks that completed bulk sales and said the stocks of those banks outperformed the KBW and NASDAQ bank indexes by 6.3% and 5.4% on average, per quarter, respectively.

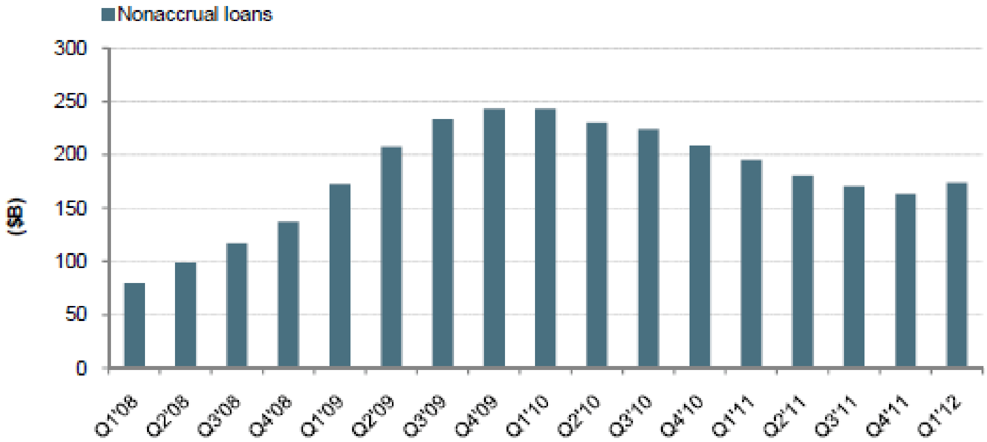
Winick said during the webinar that the market is clearly rewarding banks that reduce NPAs, and banks simply have not reduced their NPAs enough. He believes sales activity will increase in the future, though, as regulators and investors pressure banks to reduce NPAs and pricing improves due to stabilization in the underlying values of commercial real estate and buyers are able to find more debt financing.

"It's hard for us to not to think that there won't be a lot more disposition activity, especially when the marks on these portfolios are [closer to their true market values]," Winick said.

Lena Motz, managing director, commercial whole loans and REO at WMD Asset Management, said she also foresees a significant pickup in activity coming from a variety of channels.

"We expect that the market will be very active in the next three to five years whether it be through typical sales, acquisitions and consolidations that occur, and we'll see what happens with the FDIC managing tail risk. We're hopeful something cracks there," Motz said.

Aggregate nonaccrual loans of banks



Aggregate of commercial bank and savings bank regulatory filings. Does not include savings institutions.
As of May 30, 2012
Source: SNL Financial