WHEN TO AUCTION

by Steve Brown

Given expected increased pressure on CRE lending, we anticipate 2010 will be a record year for bank disposition of assets. Because of this view, a basic skill bankers should have is the experience of when to conduct and auction loans and when to try and negotiate a price.

Here at the Banc Investment Group, we sell approximately $30mm of loans per month in a variety of ways. In addition to a negotiated settlement (our most common method of asset sales), we have also conducted a variety of auctions including such types as Dutch, English, Vickery, reverse and full clearance. This gives us a good basis of knowledge in which to highlight how process design can influence outcome. Today, we focus on the simple question of when banks should negotiate and when to auction.

In an example that may have gone better, we look to the TARP program. We are not here to cast stones at TARP or say it didn't' help, simply that done another way it might have been even more effective. The structure of TARP violated one of the first rules in game theory - let the game dictate strategy. When the Treasury announced it was going to sell a variety of toxic assets via TARP in 2008 through a reverse auction (whereby prices start high and then get reduced to the point of which a trade occurs), it skipped over the issue that auctions only produce the best price when there is a liquid market. As we all know, the end of 2008 was anything but a liquid market. In addition to illiquidity, complexity also ran high, further complicating the process. All told, the assets considered back then broke down into more than 300 categories including auto loans, commercial receivables, residential mortgages, etc. In addition, each of those categories had a variety of sub-categories (such as age, FICO distribution, coupon, duration, maturity, index, credit support, etc.). The end result was that there were not enough interested bidders in each category to result in an efficient pricing process. As a result, the potentially large difference between current book price for these assets and a low and limited potential bid price created enough of a capital problem that it made the format unworkable.

In similar fashion, TARP was structured with warrants. As you probably know, warrants, unlike toxic assets, are a homogenous asset class with good information and transparency (because of a publicly traded underlying stock). Here, the game likely dictated that an auction would have produced the best price; however, the decision was made to negotiate these sales. In other words, an auction was used when a negotiation was called for and negotiation was used when an auction would have likely produced more efficient pricing.

As these two examples show, figuring out what to do is complex and underscores the importance of carefully designing the deal process to achieve the most advantageous outcome. Here, the first question bankers can ask is, "do the assets speak for themselves?" If so, auctions are almost always the best outcome when there is a transparent and easily valued asset for sale, where multiple, interested bidders can be identified and managed. It is also the ideal process when time to market matters, as a definitive schedule can be set. Here, performing multifamily, residential and most investment securities fall into this category. Depending on the liquidity of the asset, a bank should try to capture between 5 and 15 bidders to produce an optimal outcome.

Negotiations, on the other hand, are best when assets have a "story" behind them. For example, if the bid / ask difference is wide, buyers have other options or transaction costs are high (for example, where lots of due diligence is required), then negotiations usually produce the best price. In addition, a negotiated outcome is the proper design in cases where secrecy has to be maintained.

Whether you are selling an OREO or the entire bank, deal-making is not black and white. Having a working knowledge of how to conduct auctions, structure negotiations, choose between the two and when to combine them will serve to enable both the buyer and the seller to reach an optimal price.

BANK NEWS

Loan Participations

The FDIC will issue a notice of proposed rulemaking next Tues focused on loan participations. The proposal would reportedly grandfather all loan participations (and securitizations) transferred prior to 3/31/2010, as long as they complied with GAAP principles in effect prior to 11/15/09. We continue to research this and will have more information in the near-term.

More Lending Is Needed

Despite an uncertain economy, higher capital requirements, a stricter regulatory framework and a cap on compensation, President Obama is summoning the CEOs of the large banks to the White House this Monday to get them to do more lending, particularly to small business.

Comp

Speaking of compensation, Pay Czar Ken Feinberg will release his report tomorrow and it is not expected to be pretty. Our sources tell us that it is stricter than previously believed.

Foreclosure

According to RealtyTrac, foreclosure activity in Nov fell 8% from Oct (the lowest since Feb.), but was 18% ahead of last year.

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