Attachment B

Asset Exchange Example

The following is an example of a transaction used by institutions to reduce the level of nonperforming assets through an asset exchange. This transaction structure involves a trade with a third party that purchases the institution's problem assets at or very near par value. The transaction is marketed as a process for institutions to dispose of problem assets and replace them with performing assets while diversifying their loan portfolios. These transactions generally require the selling institution to purchase other assets from the same party, usually at a multiple of the assets sold, which increases risks to the regulated institution.

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.

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.