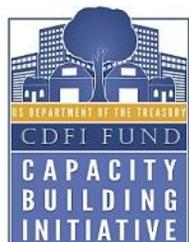


Training Module:

Improving Financial Health Part 2: Portfolio Optimization Through Asset Sales and Purchases

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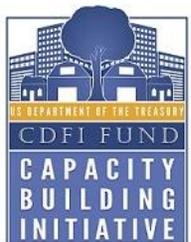
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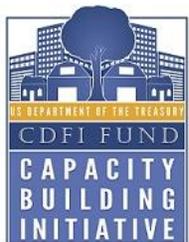
Why Optimize Your Portfolio through Asset Sales and Purchases?

- CDFI MDIs may have difficulty at times satisfying both community needs and financial performance requirements
- Portfolio sales and acquisitions are a way to manage losses and improve asset quality
- Loan losses have affected financial sustainability
- Improving portfolio optimization may help lead to new revenues, greater investor confidence and future capital raising success



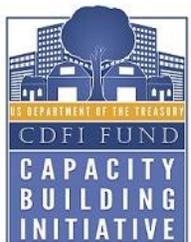
Structure of the Module

- I. Selling Distressed Assets
- II. Have You Taken a New Look at Selling Your CRA Portfolio?
- III. Buying Loan Portfolios



Goals of the Module

- To evaluate suitability and benefits of selling distressed assets
- To understand how distressed asset trades can help improve your Balance Sheet
- To demonstrate how buying assets can have an immediate positive impact on the Balance Sheet
- To understand how Community Reinvestment Act (“CRA”) sales can improve earnings



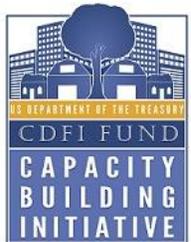
Selling Distressed Assets

Making Informed Decisions for Your Distressed Assets

How do you know if you are ready to sell in bulk?

Considerations include:

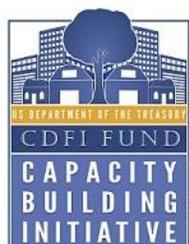
- Macroeconomic environment
- Internal workout team
- ALLL level
- Loan loss reserves
- Regulatory status
- Market prices
- Balance sheet concentrations
- Mission alignment



Strong Correlation between Asset Quality and Valuation

Market Statistics by Asset Quality			
Percent NPA/Assets	Number of Companies	Average Price/Tangible Book Value	Average Price/ LTM Earnings
<i>less than 1%</i>	262	137.6%	19.3x
<i>1% - 2%</i>	315	126.0%	20.2x
<i>2% - 3%</i>	192	115.0%	21.1x
<i>3% - 5%</i>	168	102.1%	23.6x
<i>5% - 10%</i>	149	80.8%	19.6x
<i>greater than 10%</i>	45	83.6%	14.0x
Total	1,131	117.6%	20.8x

Source: SNL Financial; Data as of 9/30/2013



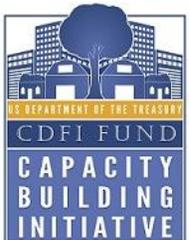
Why Sell Distressed Assets?

- **Process**

- Most institutions, including CDFI MDIs, have distressed assets on their balance sheet. These assets are a “drag” on the financial performance of the bank
- Evaluate FAS 114 to determine impairment in the allowance for loan and lease losses
- There are different investors who are active in the distressed asset marketplace buying:
 - Non-performing loans (NPL)
 - Real-estate owned (REO)
- By actively managing and disposing of their distressed assets, CDFI MDIs free up resources to focus on profitable activity vs. managing non-earning assets

- **Benefits**

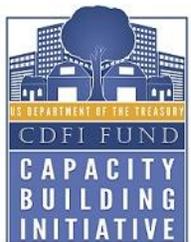
- Improve asset quality by disposing of non-performing assets
- Lower carrying cost and improve earnings
- Reduce regulatory scrutiny



Selling Distressed Loans/Other Real Estate Owned

Why sell?

- **Selling vs. “Extend and Pretend”**
 - Postponing (often hard) corrective action – “Kicking the can down the road”
 - Significant non-accruals or REO can mean serious trouble if assets haven’t been written down or charged off
 - A backlog of non-accruals with low REO is an indicator of extend and pretend
- **Regulatory Scrutiny**
 - Regulator may be taking exception to the level of non-accruals or REO
- **Capital Relief / Improve Risk-Weighted Assets**
 - Remove non-earning assets off the balance sheet
 - Free up risk based capital



Selling vs. “Extend and Pretend”

- **Sell Non-Performing Loans/Other Real Estate Owned**

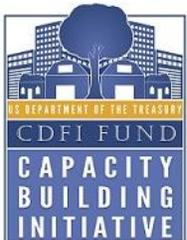
- At times, market prices exceed intrinsic value
- Avoid lengthy and costly foreclosure process in certain states
- Reduce carrying cost/capital tied up in non-earning assets
- Reduce uncertainty risk (i.e., property values, timelines, etc.)
- Improved stock price for selling a NPL portfolio
- “Bulk Sale” pool sizes range from \$1 million - \$1 billion

Example

State Bancorp sale at 185 percent tangible book value to Valley National Bank in Wayne, NJ, an attractive price after it aggressively sold its NPA portfolio.

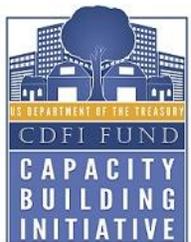
- **An Alternative: “Extend and Pretend”**

- Many large institutions have sold distressed assets; many smaller banks have retained and worked out their distressed assets
- Risks include prolonged justification of portfolio of loans at "Fair Value" (under ASC 450-20). Fair value should reflect current condition of the property and an orderly sale of individual asset or historical loss rates for bulk sale



Regulatory Scrutiny

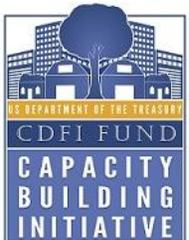
- **Written Agreements And Regulatory Orders**
 - As of June 21, 2013, 45 percent of the CDFI MDIs were under enforcement action including agreements, consent orders, and cease and desist orders
- **These Orders State That Each Regulator Will Likely Take Action If:**
 - Having aged assets is causing inadequate capital
 - Operating with an excessive level of criticized assets
 - Operating without effective underwriting standards and practices
 - Operating without an effective loan documentation program
 - Failing to provide for an effective system to identify problem assets and prevent deterioration



Improve Risk-weighted Assets

- **Taking Non-performing Assets Off The Books:**
 - Improves asset quality
 - Reduces risk based assets and reduces capital requirement
- **Considerations**
 - Have the assets been written down/charged off sufficiently to support a sale? If not, there must be adequate Tier1 and Tier2 capital to support the difference.
 - Is the level of ALLL enough to support a loan sale?

Example: Bank A has \$4 million in non-performing multifamily notes. If the going rate for non-performing multifamily loans is 50 cents on the dollar, then that means that the \$1 million in reserves will only cover about \$2 million in product. Although the bank has \$4mm in non performing loans, they only have enough reserves to cover a sale of \$2mm. The bank needs to make sure they have enough ALLL to cover a sale.

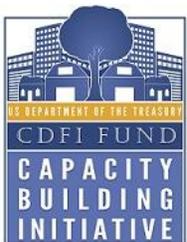


Looking at Today's Loan Marketplace

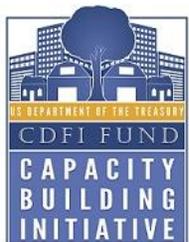
Finding Loan Investors

- **Performing Loans**
 - Federal Home Loan Bank System (FHLB)
 - Local and national banks
 - Wall Street trade desks (seasoned loans, non-conforming loans)
 - Government Sponsored Enterprises (GSEs) cash window
- **Sub-performing, Re-performing, Non-performing Loans**
 - Loan brokers
 - Hedge funds/private equity funds
 - Wall Street trade desks

Tip: Do your home work on investors, talk to peers, references, and competitors about operations, pricing and guidelines. You want to determine the positives and negatives of working with them



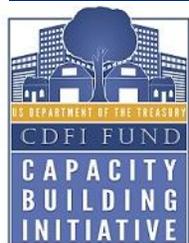
What Buyers Expect when Purchasing Assets



Sample Market Prices for Bulk Portfolio Loan Sales

Asset	Prices as of January 8, 2014*
Residential 1-4 performing	4%-6% yield (new original non-agency)
Residential 1-4 non-performing	7%-9% yield. Prices are low 60s-mid 70s to broker's price opinion (BPO) depending on state
Residential 1-4 re-performing	5-8% yield (modifications, re-performers i.e. troubled-debt restructuring (TDRs)). Prices high 60s to 80s/90-day BPO depending on current LTV
Commercial real estate loan-performing	101-105% (prepay penalties, high coupons, 10-yr balloons)
Commercial real estate loan NPL	Prices ~ 70% of collateral value
Auto loans	Ultra prime=2% yield; Prices \$103-105
Credit cards	Prices ~ \$105 to \$112 area
Consumer- Nonperforming	Charged off and NPL consumer loans trade in 5-10% of unpaid principal balance (UPB) area

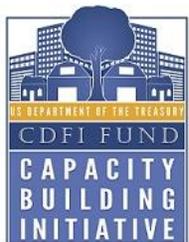
***Prices are subject to change**



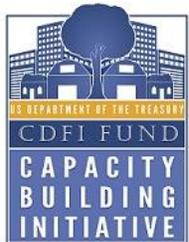
How Do Buyers Get to These Prices?

Distressed asset valuations are primarily driven by:

- **Underlying Costs of the Due Diligence Process**
- **Property or Asset Valuations Today/Forecasts**
 - Current value versus value trends
 - Market forecast versus your local asset forecast
- **Data Integrity**
 - If the data on the initial pricing tape does not match the data in the loan files, it will result in an adjustment in price
- **Leverage**
 - How the investor will be funding the transaction: borrowing, cash, both
- **Worse Case Scenarios**
 - Economic trends
 - Demographic trends
- **State**
 - Prices vary between states with judicial and non-judicial foreclosure procedures
 - Examples of recent pool prices in judicial states include IL=57%, FL=68%
 - Examples of recent pool prices in non-judicial states include AZ=81%, CA=76%, UT=75%



Distressed Portfolio Loan Sale Process



Phase 1: Prepare for Sale



Prepare and verify portfolio available for sale



Hire loan sale advisor



Establish reserve price



Develop and implement portfolio marketing plan

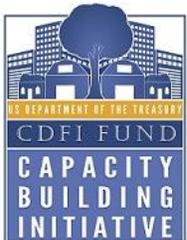
- Identify loans to be sold
- Prepare data tape to be given to the investor

- Identify and hire firm to help structure and manage the sale
- Most already have relationships with firms they could use
- Should be knowledgeable in all aspects of a loan sale
- Enter into NDAs

- Work with financial advisor to determine the bid review and acceptance criteria
- Leave room for negotiation

- Identify investors that will be shown the pool of loans
- Establish bidding process including due date and time for bids

Tip: Take the time to verify loan data against loan files. Clean data going in will help expedite the process throughout. Discrepancies in the data can lead to major price adjustments or failed trades



Phase 2: Due Diligence and Review

Phase 1: Prepare for Sale

Phase 2: Due Diligence & Review

Phase 3: Negotiations

Phase 4: Execution & Closing

Review bids and award decision



Investor issues letter of intent

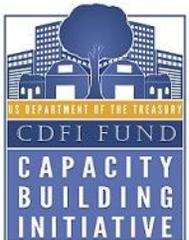


Deliver your loans to investor for due diligence

- Analyze bids for best execution
- Select best bid
- Notify winner and losers

- Letter of intent does not bind the investor
- Quotes an indicative price
- Price will not change as long as the data and loans do not change

- Investor verifies that the data in the file submitted for pricing matches that of the loan file
- Discrepancies need to be addressed
- Can be done via data room where the investor has access to loan file data through a secure link
- Could also involve physical delivery of copied loan files



Phase 3: Negotiations



Investor resolves due diligence issues & adjusts price

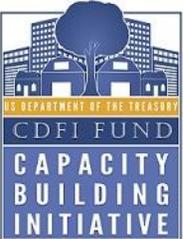


Final agreement of price

- Buyer and seller resolve any differences between the pricing data file and the loan files
- Address any title and legal document issues
- The price may be adjusted based on verified differences

-
- Buyer and seller agree on final price based on data verified in due diligence

Tip: Don't just go for the highest bid. Consider intangibles like number of deals closed, time to close, and carve outs. You want to pick the bid which offers the highest proceeds with the highest probability of closing in the shortest amount of time



Phase 4: Execution and Closing

Phase 1: Prepare for Sale

Phase 2: Due Diligence & Review

Phase 3: Negotiations

Phase 4: Execution & Closing

Execute MLPA/MLSA and ISA

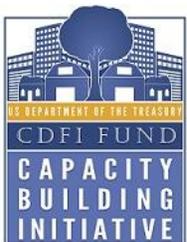


Closing



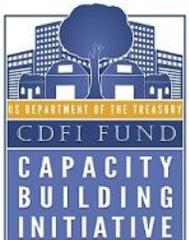
Execute servicing transfer

- Mortgage Loan Purchase Agreement (MLPA) or Mortgage Loan Sale Agreement (MLSA) are binding agreements which lock in terms of the sale
 - The Interim Servicing Agreement (ISA) determines how the loans will be serviced until servicing is transferred to the buyer
-
- Loans are transferred to the buyer
 - Sale proceeds are transferred to the seller
 - Typically done through a third party/escrow agent
-
- After the sale, servicing is transferred to the buyer
 - Typically the servicing transfer occurs 30 or 60 days post sale
 - The seller services until the transfer and remits to the buyer



An MDI Recent Distressed Asset Sale Outcome

- **Scenario:** An MDI had too much concentration in one loan product and was coming under regulatory scrutiny due to concentration limits
- **Transaction:** They worked with a broker to:
 - Identify the most marketable assets with the highest probability of a competitive price
 - Scrub the data
 - Market the pool to buyers
 - Negotiate pricing for their unique product
 - Conduct rigorous analytics that were required to show risks vs. benefits
- **Lessons Learned:**
 - The bank was able to get regulatory relief and a good price for their loans
 - It was discovered that the loans were higher-cost loans during due diligence which required negotiation and price adjustment. Care must be taken to discover all relevant information to avoid possible deal termination
 - The reasons for portfolio sales do not always have to be economic



Have You Taken a New Look
at Selling Your CRA
Portfolio?

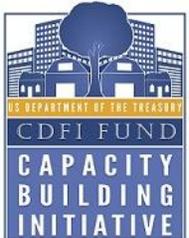
Why Sell CRA Loans?

- **Process**

- CDFI MDIs originate loans that are concentrated in CRA compliant areas or that are made to CRA compliant borrowers
- CRA loans may be sold as whole loans, but more commonly residential CRA loans are securitized and sold as CRA Mortgage Backed Securities (MBS)
- There is demand across the country from banks that are not in CRA rich areas
 - These banks need to originate or buy CRA eligible loans to comply with CRA lending or Investment test requirements
 - CDFI MDIs have an opportunity to sell CRA loans into investor demand
- By increasing CRA loans, CDFI MDIs can grow origination fees and gain on sale revenue

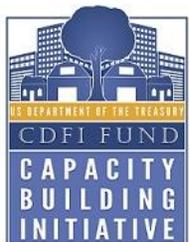
- **Benefits**

- Increase community lending while increasing profits
- Reduce exposure to local concentration risk
- Summary: Increase growth, reduce credit risk, serve the community, and make profits to achieve social and financial goals



CRA Eligible MBS Marketplace

- CRA loans can also be securitized into a CRA eligible mortgage-backed securities (MBS)
- Payups: To Be Announced (TBA) MBS + payup by bond coupon
- Loans must meet agency guidelines
- Two types of CRA MBS
 - Low/mod income CRA MBS
 - Low income = 50 percent of area median income (AMI)
 - Moderate income = 50 – 80 percent of AMI
 - Census tract CRA MBS
 - HUD.gov low/mod income census tracts
- Minimum of 51 percent concentration allowed up to 100 percent
- Buyers: community banks, commercial banks, money managers
- Competition: Fannie Mae, Wall Street MBS trading desks
- Other MBS pay-ups: low FICO, high LTV, low loan balance, Home Affordable Refinance Program (HARP)



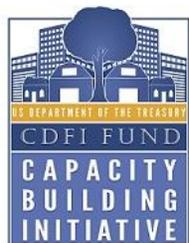
Tip: CRA MBS are sold for CRA Investment Test credit

CRA MBS Marketplace Illustrative Data

CRA Trader's inventory as of September 2013:

MSA/City	Security	Attributes	Pay-Up
Dallas, TX	GN AD8773 1.3MM	100% LLB/100% LMIB	+8/GNSF 3.0
Houston, TX	GN AF5042 1.5MM	88% LLB/100% LMIB	+20/GNSF 3.5
Nassau, NY	FN AU6666 1.7MM	15yr/23% LLB/100% LMIB	+22/FNCI 2.5
Mixed NYC	FN AU3776 1.5MM	15yr/18% LLB/88% LMIB	+16/FNCI 2.5
Miami-Brow, FL	GN 779067 1.1MM	100% LLB/100% LMIB	+10/GNSF 3.5
Phoenix, AZ	GN AF5043 1.5MM	73% LLB/100% LMIB	+16/GNSF 3.5
St. Louis, MO	FG Q20854 1.6MM	100% LLB/100% LMIB	+15/FGLMC 3.5
Tampa, FL	GN AD8776 1.2MM	100% LLB/100% LMIB	+8/GNSF 3.0

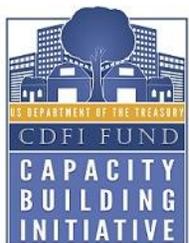
Source: Data from Wall Street Trader, as of September 2013
For illustrative purposes only.



Related MBS Pay-ups Illustrative Data

Example-only

MBS Pool Type	Pool Attributes	TBA + Pay-Up, by Coupon
Low FICO	FICO < 700	4.0%=+1/32; 4.5%=+5/32 5.0%=+36/32
Low Loan Balance	AOLS < \$85,000	3.5%=+5/32; 4.0%=+9/32 4.5%=+22/32
Medium Loan Size	AOLS \$110,000 - \$124,000	3.5%=+4/32, 4.0%=+6.5/32, 4.5%=+18/32
NOO	100% Investor	4.0%=+1/32, 4.5%=+1/32, 5.0%=+26/32
High LTV	LTV 100% - 105%	4.0%=+1/32, 4.5%=+8/32, 5.0%=+50/32
HARP 2.0	LTV 125% and Above	3.5%=-40/32; 4.0%=-32/32 4.5%=- 13/32
Puerto Rico	100% Pool	+3 to +10/32



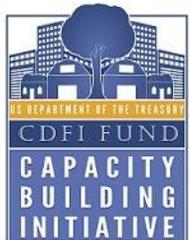
Source: Wells Fargo Securities- MBS Trading as of January 9, 2014.
For illustrative purposes only.

Buying Loan Portfolios

Buying Loan Portfolios

Consider buying loans if you've done one of the following:

- **If you've sold a distressed portfolio**
 - You need to replace longer duration assets
 - Replace interest margin
- **If you're selling CRA loans**
 - Purchase higher quality assets
 - Replace longer duration and margin
- **If you need to reduce concentration risk**
 - If you are seeking to diversify by geography, product type, product quality, and customer
- **If you are seeking to rebalance yield, interest-rate exposure or portfolio profitability**



Why Buy Loan Portfolios?

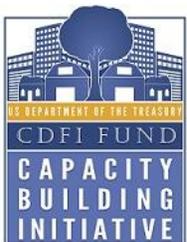
Process

- Banks often need to improve performance of their credit quality or add higher yielding assets. They may not have the ability to originate high quality loans
- Large aggregators have excess loans across the country that they will sell to other banks – including high quality, agency eligible loans
- CDFI MDIs can work with a broker-dealer to negotiate the purchase of these assets

Benefits

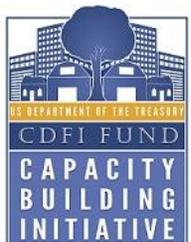
- Earn more yield in today's low rate environment
- Gain exposure to an improving economic climate and hand pick your loans
- Loans are a good source of yield in today's market versus bonds
- Rebalance yield, credit exposure, interest rate exposure, or portfolio profitability

Tip: Buying loans is often cheaper and faster than originating loans, and allows you to hand pick customers that align with your portfolio needs



Challenges/Risks

- Many institutions may not want to sell loans for the same reasons you might want to buy them: margin, duration, improved asset quality
- Due diligence is very important since the asset will belong to the bank for a long time
- Closing whole loan trades takes a strong internal leadership team in areas of secondary marketing, loan file reviews, legal, servicing transfer, and accounting



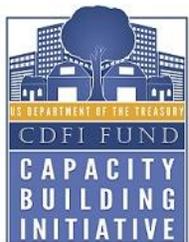
Sources of Loans

- **Other Banks Are a Good Source of Loans**
 - Larger banks who regularly trade their assets
- **Check with Broker Dealer Contacts**
 - Leverage resources to help find loans
 - Often all you have to do is put the word out that you are a buyer
 - Have your broker watch for bulk loan sales
 - Utilize broker to perform pro forma analytics of the purchase on your balance sheet

Today's Jumbo Loans

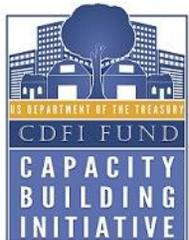
Securitization dried up.
Some banks buy
Jumbo Loans to:

- 1) Pickup low risk borrowers
- 2) Cross sell
- 3) Buy 3-5 points
BEHIND TBA prices
for a big yield



A CDFI MDI Recent Asset Purchase Outcome

- **Scenario:** The CDFI MDI needed to buy loans because the targeted amount of residential loan originations in 2013 was low due to slow first quarter originations. The bank decided to purchase high quality residential loans in their foot print
- **Transaction:** The original trade was \$20 million and upsized to north of \$25 million; Sold servicing released; Trade was consummated through a loan broker; Loans were 15, 20 and 30 year agency eligible loans offering liquidity; Closed in the 3rd quarter of 2013
- **Lessons Learned:**
 - The net effect was the bank was able to obtain a good sized, high quality loan portfolio at a market yield in 45 days
 - Buying bulk portfolios creates an opportunistic tool to manage your balance sheet needs



Wrap-Up

Key Takeaways of Training Module

- **Selling Loans Can Help You:**

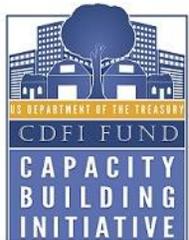
- Avoid the lengthy and costly foreclosure process
- Reduce carrying cost/capital tied up in non-earning assets
- Improve asset quality
- Reduce uncertainty and macroeconomic risks
- Avoid regulator scrutiny

- **Selling CRA/Pay-up Loans Can Help You:**

- Increase growth, reduce credit risk, serve the community, make profits to achieve social and financial goals

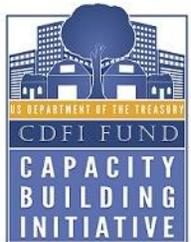
- **Buying Loans Can Help You:**

- Improve margin and duration, improve asset quality, and diversify risk

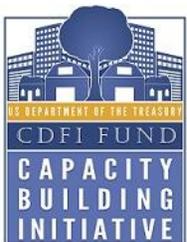


Examples of Potential Technical Assistance

- Guidance on the process to sell distressed assets and key leading practices
- Provide market background, knowledge, and current prices for assets
- Guidance on how to approach and prepare for a portfolio sale
- Due diligence when buying loans - importance of knowing what you are buying and the risks
- Provide bid pricing analysis for loan purchase transaction
- Support with pooling sellers/shared transactions



Questions?





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