

Debt Sales 101 Mini-Series (Episode 3): Who Buys Debt and How Deals Are Structured

Speakers: Joseph Schuster and Chris Eastman

Joseph Schuster:

Welcome back to episode three of our Debt Sales Miniseries podcast. I'm Joseph Schuster, a partner in the Consumer Financial Services Group at Ballard Spahr. And as a quick recap, so far we've talked about what a debt sale is, why companies sell debt, and what types of debt are typically eligible for sale. Chris, I'll turn it over to you to introduce yourself and maybe introduce our third episode.

Christopher Eastman:

Yeah, good morning, Joseph. It's good to be with you again. I'm Chris Eastman. I lead Franklin Ross Strategies, a consultancy that works with companies, among other areas, with debt sales. We help bring recoveries optimization and debt sale to market for sellers.

In our third episode today, really excited about this one. We're going to be talking about who buys charged off debt and how debt sales are structured. And really, here, we see a broad variety of companies specializing in buying debt across various industries. Some debt buyers, Joseph, specialize in very specific types of debt, as you know. So there'll be buyers that only do medical debt or they'll specialize in telecom debt, but most buy a variety of consumer financial debt, and it's really based on their ability to underwrite a specific product type and their past experience and success collecting on that product type. So oftentimes you'll see buyers do a combination of credit cards, personal loans, maybe some audit deficiencies, LTO, lease to own type products. But Joseph, how do buyers generally think about that from a legal perspective?

Joseph Schuster:

Yeah, it's a great question, Chris. I'm also really excited about this episode because this is really where the legal, the regulatory and the commercial considerations really start to converge. From a legal perspective, buyers are really underwriting legal and regulatory risk as much as they're underwriting the credit risk, or what you'll probably refer to as yield. At a high level, buyers are looking at, I'd say, three overlapping buckets. First is transferability. Can a debt be sold? Does the seller have clean title and documentation to support that transfer? And can the buyer purchase that debt? Do they have all the licenses? Is it something that they've purchased before? Is there an uplift that they need to do in order to be able to enter a new vertical? Second is collectability. Not just whether the consumer owes the balance, but whether the buyer can lawfully collect it through their intended strategies. There are things like statute of limitations to consider. Various states have limitations on different collection strategies.

So this can include whether the buyer is going to collect it themselves, whether they're going to use agencies, or whether they're going to pursue a legal collection strategy. The third bucket is really regulatory exposure. What laws apply to the product, the consumer population that's involved, where that debt is located. You will always see in offering memorandums, the debt spread across different states because different jurisdictions have different limitations. And considering those jurisdictions, the laws associated with it, there's a lot there in that third bucket. I'd say that buyers tend to be very product specific here. Credit cards, personal loans, auto deficiency balances, BNPL, all of these, and every other product comes with a different regulatory overlay and a different litigation risk profile. Buyers with strong compliance infrastructures may be comfortable in a higher regulation environment or products that are subject to more regulations. And some of the others will limit to a specific vertical, whether that's credit card, installment loan, whatever that case might be.

What I many times will tell sellers that I'm advising is that buyers are pricing not just the portfolio, but also the certainty that they can step into those seller's shoes. And the more certainty there is that they understand the regulatory profile of the seller, the regulatory risks associated with what they are buying, the more certainty they're going to have, and that's going to impact the price. Now, I know our fourth episode is going to get into the regulatory consideration, so I don't want to go too far into

the weeds on this topic, but I will add that over the past several years, regulatory considerations have been increasingly a driver of pricing, buyer appetite, those types of things. Buyers are looking closely at state by state issues, licensing requirements, statutes of limitations, litigation trends, and enforcement posture, especially for products that contain more risk like medical debt, student loans, accounts involving servicing or dispute histories.

And this is where sellers sometimes underestimate the importance of this alignment. They think that they have a product and the market's going to price X product at this, and the regulatory piece can really affect that pricing. A portfolio that looks commercially attractive can very quickly lose value if there's uncertainty around the client's documentation or the history of the consumer interactions here. Again, we're going to spend a full episode on regulations next. So the short version here is that sophisticated buyers are absolutely factoring regulatory risk into pricing structure and even whether they participate at all. So Chris, with that in mind, we generally advise on the seller's side. How do sellers think about this risk right now and how do you find the right buyer?

Christopher Eastman:

It's a great question, Joseph. And I think you called out a really important point, it's really the convergence with buyers around experience in a product and willingness to align along those risks that you were just discussing. But I think there's another important component here, and it really is around identifying buyers that are well-funded to support the purchase. And this really entails two critical components. The first one is a well-funded buyer can fully invest in maximizing the portfolio value. They do this really by identifying and underwriting which accounts may be eligible for different types of collection strategies, whether it be in house and agency or a legal recovery strategy. And a legal recovery strategy generally requires significant upfront investment on the buyer's part to file suit, to ensure a customer is properly served, and then to move through the courts and post-judgment processes. Now, a well-funded buyer will optimize across these strategies to maximize their expected returns, and in doing so, that'll enable them to bid a higher price for the debt sale.

So this is really where a well-funded buyer that has a lot of experience in the space can oftentimes bid a higher price on a debt sale than someone maybe new to the vertical. Now, I'm very fortunate that I've had the opportunity to work with several large, well-funded buyers, and I've been able to vet them. And when I work with clients, I actually often focus on leveraging these relationships to ensure success through the process and that things move forward to close at pace. Now, the second thing I would call out is a well-funded buyer also needs to have access to capital required to fund the purchase price. This is really achieved through a combination of the buyer having sufficient cash on hand and credit lines that they maintain with lenders. Buyers that have large lines and low access cost of credit will really be able to bid more aggressively on deals and will also fund those deals quickly, oftentimes for significantly larger amounts in terms of purchase price.

So well-funded buyers also have reduced liquidity and cash flow risk with a forward flow set up. So that's an important consideration as well as you're thinking about ongoing sale processes and structures.

Joseph Schuster:

One thing that I will add too, Chris, as we're looking at who you're looking at for a buyer and the regulatory risks and how all of these converge is that the seller might be thinking about their posture and how they've collected on this debt and the customers that they have who are involved. And I know that we're going to get into a little bit about how the deal is structured, but as the seller's representing what they've done with these accounts to the buyer, the seller may also have limitations that they want to impose on those sales as well. You've talked about different strategies that can be used, legal strategies, different collection strategies. There may be limitations that the seller wants to impose, and they can impose those limitations.

We caution against being too involved in what the buyer's doing from a collections perspective so that you're limiting your risk going forward, but prohibiting certain types of activity or limiting certain types of activity because the seller wants to limit how the buyer is interacting with their customer, and their customer might have certain other relationships with them, is something, and that can affect the price as well when you think about these deals and pricing them. But with that, as we think about those different things, getting really down to what the deal is and how the deal is structured, would you be able to talk about the high level different types of deals?

Christopher Eastman:

Yeah, absolutely. Really, there's a couple of major types of sales that are generically or usually seen in the market. The first is a spot sale. This is a one-time transaction involving a defined pool of accounts. Often older charge-offs or specific vintages of charge-offs, buyers price the pool based on what's included and deliver a bid for that specific sale. The other is a forward flow arrangement, and it's more programmatic in nature. Buyers agree in advance to purchase future charge-offs, often monthly or quarterly, at a pre-negotiated price or pricing formula, and they usually go for a fixed term such as 12 months. These arrangements really create predictability for both sides and often rebid annually to keep pricing competitive and ensure there's a broad market of interested buyers that a seller can turn to if need be.

Joseph Schuster:

Yeah. And I think maybe here we talk a little bit about repricing risk as well, Chris. I think that the repricing risk is something that particularly exists in the forward flow arrangements. Like you've talked about with the capital that buyers have, buyers are committing that capital in advance based on assumptions about regulatory stability, litigation costs, recoveries. If those assumptions are shifting materially, if that regulatory landscape is shifting, if there are enforcement actions against the seller, the type of product, all these different items, the risk allocation will generally shift. And what we put together in the agreement tries to protect against this as much as possible, but there is always an element of this out there to be mindful of. This is where, too, I think that segmenting portfolios can be particularly important, and we are seeing that more and more, I'd say. For example, bankruptcy only portfolios, debt settlement accounts, the age of different debt that's within portfolios, you will see some of those segmented.

And I think that that can help with the pricing there as well if you have different buckets as opposed to a buyer trying to put one price on all of these assets. From a legal perspective, these can also be very effective in terms of carefully scoping and avoiding inadvertently transferring accounts that weren't intended to be sold, or that the seller wants to make sure that there are certain specific items in those purchase and sale agreements. Chris, anything that you would add here?

Christopher Eastman:

Yeah, Joseph. I would say you're spot on when it comes to the forward flow. Any buyer is going to be re-underwriting those forward flows almost on a monthly basis to validate that the accounts that they're purchasing are materially similar. So if they start seeing a different mix in terms of state or credit quality, this is also going to create risk around repricing for the seller. So they need to ensure that what they're bringing to market is materially similar on a monthly basis. I'd say the other thing I would highlight here is that if the goal is to do both a spot sale of older debt and a forward flow for future charge-offs, you'll really want to set up the forward flow first. That ensures that the spot deal is a defined set of accounts, and the order is important to avoiding a situation in which you're always chasing sort of a small bit of trailing accounts from the forward flow that need to go into the spot sale. So always set up your forward flow first, then on the back of that, execute your spot sale.

Joseph Schuster:

Great. Well, maybe we wrap it up here. So the key takeaway from this episode is really that debt sales are not one size fits all. While we do have a specific process that we generally follow in terms of the RFP, the offering memorandum, the diligence questions, the starting points for PSAs, those vary based on portfolios, the types of debt that we're selling, the clients who we're representing. There's a lot of intricacies in here in terms of who's the buyer, how the deal's getting structured and how the risk is being allocated within these. So we're going to get into more detail on that in our next episode here.

In that episode, we're going to zoom in on the regulatory environment governing debt sales today. We'll talk about what's changed recently, what's emerging, and where both buyers and sellers need to be particularly careful.

