ASK ALM FIRST

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Why Should Depositories Consider Loan Transactions Now?

When constructing a financial institution's balance sheet, savvy financial managers understand the importance of evaluating all asset classes, including whole loans and loan participations. As many depositories find themselves with excess liquidity, this evaluation process may be critical now.

Just like a securities investment or loan origination, incorporating the secondary whole loan market into balance sheet strategy can often improve institutional performance. In an economic environment that is causing many depositories to increase their allowance for loan losses significantly, we believe considering appropriate performance enhancement opportunities is vital.

Key Characteristics to Consider
The most direct drivers of a loan pool's price are the collateral characteristics. These include:

- Coupon (WAC)
- Credit quality
- Weighted average maturity (WAM)
- Servicing type

When analyzing a pool, everything starts with the coupon. Higher coupons drive higher yields (assuming a constant price), and vice versa for lower coupons. The gross weighted average coupon (GWAC) is the starting point from which servicing fees are netted out, if applicable. It is from these cash flows that the yield and loss-adjusted yield are calculated. Coupons that are too low for the risk will look unattractive on a loss-adjusted basis.

How Institutions Evaluate Risk

An obvious concern for any investor in a loan transaction is the ability to be repaid. Evaluating the credit riskiness of a loan pool is at the top of the list when seeking to assess its relative value. Important metrics to utilize include:

- Loan-to-value (LTV)
- Debt-to-income (DTI)
- Debt-service coverage ratio (DSCR)

Historical loss rates serve as an important anchor to the credit loss assumption in the pool pricing. High and/or volatile loss rates may indicate a need to dive deeper and could adversely impact the price due to increased uncertainty regarding loss rates.

Other Factors Impacting Marketability

The WAM on a pool can impact marketability, and it also plays a direct role in its estimated weighted average life (WAL). Typically, depository institutions need shorter assets, since credit exposure increases with increasing WAMs.

Servicing execution plays a role in marketability as well. Servicing-released execution in many cases increases the marketability of a loan pool and increases the number of potential buyers. However, the loan participation market is also relatively deep and can offer an outlet for those looking to execute on a servicing-retained basis. The tradeoff in value ultimately depends on the seller's/servicer's reputation, the nature of the investor/servicer relationship, and the investor's ability to service.

In a participation arrangement, the investor's rights to interact with the borrower may be limited and will depend on the agreement between the two parties. However, this is a necessary evaluation in a servicing retained agreement where consideration for both the assets and borrowers is critical. A poor servicing record, financial instability, or bankruptcy can severely reduce or eliminate the return to the investor. Although, if the investor's cost to service is prohibitively high, servicing-retained execution could lead to more favorable economics.

The Importance of Counterparty Reputation

Counterparty considerations may be important for buyers from a marketability and compliance standpoint. If a seller/originator has a proven track record in the secondary market and significant servicing experience, its pools will more likely translate into increased marketability. The financial health of the seller can also play a role as it can instill confidence and help expedite the due diligence process. Additionally, a more qualitative factor is the evaluation of the key employees of the selling institution. This can range from lending officers all the way to

the executive management team and serves to provide a more thorough picture of the seller and its reputation.

Counterparty and reputation considerations also arise from a compliance standpoint. Buyers want to know lenders have procedures in place to maintain compliance with the CFPB and other lending regulations. Indirect lending programs come with a host of additional considerations, including managing dealer relationships and pricing.

Lastly, servicing reputation, if applicable, is also a big factor. How experienced is the seller in servicing? If the seller is retaining servicing, it is important that it demonstrates proficiency in servicing the loans. Does it have appropriate collections procedures in place? The collections operation is important to managing credit losses.

Benefits of Tapping the Whole Loan Market

Assessing the relative value that whole loans and participations can provide, we believe, is a must for all shrewd balance sheet managers. Not only can this exercise enhance performance, but it can also tap into the secondary whole loan market to address a bevy of institutional needs, including:

- lack of organic loan growth
- alleviation of liquidity or concentration risk
- expansion of asset and revenue diversification

Regardless of the avenue, secondary loan markets should be viewed the same – as an important and necessary tool for well-rounded depositories.

Learn more about our user-friendly **Loan Transaction Network** today.

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