

IBI Credit Union Services Presents

Investing in Government Guaranteed Loans

The Risks and Benefits for Credit Unions 2011

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CREDIT UNION SERVICES
A division of Isaak Bond Investments

Our Objectives

The purpose of this White paper is to provide some suggestions to member credit unions about investments they can make that are safe, sound, comply with part 704 of the Credit Union Act where it applies, and have liquidity and enough yield to provide the basis for a good dividend rate on share deposits, an operating margin for overhead, and excess to rebuild retained earnings. Moreover, the investments we are going to talk about in this white paper do not require additional staff and overhead and do not impose an administrative or servicing burden on the credit union, except for entering the balances and income streams from the statement each month.

There are three ways to grow a profitable loan portfolio. One is by originating loans within your field of membership, or through your CUSO, through a solid credit process. Another is to purchase participation loans. And the third is to purchase government guaranteed loans.

For some very good reasons, guaranteed loans are an exciting and suitable strategy for today's credit unions. If you have slack loan demand, they can keep your assets growing. If you have rising delinquency, guarantees are an attractive zero principal risk asset that increases out standings and, hence, reduces delinquency as a percentage of receivables. If you are worried about liquidity, guaranteed loans trade daily in a \$50 billion US secondary market. And pools of these loans can be pledged to the Federal Home Loan Bank as collateral up to 97 cents on the dollar.

Guaranteed Loans versus Participation Loans

Credit Union analyst Lydia Cole, with Callahan Associates, wrote recently that participation loans - that is, secondary market purchases of one credit union's loans by another -- have gained popularity markedly across the country, as a way to offset slack loan production during the recession. Credit unions, as Lydia points out, hold \$10.4 billion in outstanding participation loans. Approximately 16.5% of credit unions have at least \$1 outstanding in participation loans, and 205 larger credit unions (or 2.7%) hold more than \$10 million in participations. 15 institutions hold \$2.8 billion, which is a quarter of the total industry holdings.

The individual guaranteed loan investments we are talking about in this paper are, to some extent, a version of participation loans. But then again, they are quite different.

- Like participation purchase, individual, government guaranteed loans go on your loan portfolio along with participations.
- Like most participation purchases, these loans are serviced for you. You get a monthly statement and an ACH transfer or check
- Like participation purchasing, guaranteed loan purchasing is not as overhead intensive as origination. You can buy a lot of loans with a much smaller staff and the process is much shorter.

- Unlike guarantees, participations carry credit risk. If the borrower defaults, you and the originating credit union share the risk proportionately to your investment.
- Unlike participations, the part you buy with an SBA or USDA guarantee is guaranteed as to principal and accrued interest, irrevocably, by a corporation of the United States government. Thus, unlike participation loans, guarantees have no (zero) principal risk and zero accrued interest risk. They are repurchased, at par, by the SBA or USDA or other agency in event of default. The servicer deals with the borrower – and with the SBA and USDA.
- Unlike participation purchases, which are often made at or near par, guaranteed loans trade at a substantial premium and hence carry the risk that they might pay off before you have amortized the premium. Clearly, premium risk is a lot less than risking default on an entire loan – but it is a risk you can largely protect yourself against and we will be addressing this at some length here.
- Unlike participation loans, SBA and USDA guarantees trade in a very active %+\$50 billion secondary market. (Our \$50 billion figure includes loans placed in pools, which are then sold as pass-through securities like FNMA and FHLMC and GNMA mortgage pass-through).

Guaranteed Loans versus Pools

The other way to invest in government guaranteed loans is to buy an undivided interest in a pass-through security, or pool. These investments go in your securities portfolio. They can be pledged for liquidity. Most pools adjust monthly or quarterly, although we are seeing some 3 and 5 year pools, and fixed rates these days. But most of pool investments serve the “short bucket,” that is to say they have characteristics which match pretty well to share dividends.

Types of Government Guaranteed Loan Investments

The most popular and widely traded government guaranteed loans are SBA 7A guaranteed loans (individual loans and pools) and USDA guaranteed loans. And we will focus on these in this paper.

Small Business Administration (SBA 7A) Loans

The SBA 7(a) loan guarantee program provides long term financing for small businesses not normally available through conventional commercial lending channels. This program provides the nation's small business community with manageable long term debt service. These guarantees are issued to qualified credit worthy borrowers whose loan applications meet the criteria of both the lending institution and the Small Business Administration. The maximum SBA 7A loan is \$5,000,000. Loans can now be guaranteed to a maximum amount of 75% of the outstanding principal, so the maximum guarantee is \$3,750,000. The originating credit union, Credit Company or bank keeps the non guaranteed portion and services the loan. The guaranteed portion is frequently sold on the secondary market at a large premium – currently 8 to 12 percent. This is true of the SBA 7A and each of the loan types discussed below.

Most SBA 7A loans adjust monthly or quarterly. They all pay monthly. Most have a high cap on the rate, or no cap at all. Hence, these 7A loans are a good match against short term share drafts and short term share certificates. And they are a good hedge against inflation.

Some SBA 7A loans you will see are fixed for the term – 7,10,15, 20 or 25 years. These carry extension risk, just like long bonds do. If rates rise, they will “stick” on the books, their value will drop, and they may not maintain enough margin over your cost of funds. Most credit union buyers look for the adjustable product – or a hybrid fixed for 3-5 years which then adjusts quarterly or monthly.

SBA 7A loans typically have a substantial prepayment penalty – 5% of the amount voluntarily prepaid year 1, 3% year 2, 1% year 3. The SBA retains any prepay penalties on SBA loans. But on USDA loans (below), you keep the prepayment penalty, as long it is not from default, and it is often substantial.

United States Department of Agriculture (USDA) Business and Industry Loans

Loans guaranteed by the United States Department of Agriculture (USDA) are traded nationally in an active secondary market and offer credit unions and other investors a unique combination of safety, attractive yields and, if adjustable, rate sensitivity. The USDA guarantees loans through many programs. Most of the product you will see for sale falls under the B&I (Business and Industry) program. Typically, the loan is fully amortized over a term of up to 25 years. Terms are shorter if the collateral is equipment. The rate may be fixed for 1 to 10 years, then adjust quarterly over Prime or LIBOR, or adjust every 3 or 5 years. Or, the loan may adjust monthly or quarterly from the very start of the term. The purpose of the USDA’s B&I program is to improve, develop, or finance business, industry, and employment and improve the economic and environmental climate in rural communities. This purpose is achieved by bolstering the existing private credit structure through the guarantee of quality loans which will provide lasting community benefits. It is not intended that the guarantee authority will be used for marginal or substandard loans or for relief of lenders having such loans.

A USDA borrower must be engaged in or proposing to engage in a business that will:

1. Provide employment;
2. Improve the economic or environmental climate;
3. Promote the conservation, development, and Rural Development, Business and Cooperative use of water for aquaculture; or
4. Reduce reliance on nonrenewable energy resources by encouraging the development and construction of solar energy systems and other renewable energy systems.

USDA guarantees loans after the Business and Industry underwriters in the local USDA Field Office, and the originating lender, both have underwritten the credit. USDA loans can be used for:

- a. Business and industrial acquisitions when the loan will keep the business from closing, prevent the loss of employment opportunities, or provide expanded job opportunities.
- b. Business conversion, enlargement, repair, modernization, or development.
- c. Purchase and development of land, easements, rights-of-way, buildings, or facilities.
- d. Purchase of equipment, leasehold improvements, machinery, supplies, or inventory.

The maximum percentage of guarantee is 80 percent for loans of \$5 million or less, 70 percent for loans between \$5 and \$10 million, and 60 percent for loans exceeding \$10 million. The originating bank or credit union retains the non-guaranteed portion of the loan.

Prepayment penalties on these loans are frequently 5% flat for 5 or 10 years, or 10/9/8/7/6/5/4/3/2/1 years 1-10. Some of the quarterly adjustable may have little or no penalty for an early adjustment. Unlike SBA guarantees, USDA guarantee buyers get the penalty unless the borrower is in default.

Small Business Administration (SBA) Pools

The collateral for SBA pools is loans to small businesses that are guaranteed by the full faith and credit of the U. S. Government as timely payment of principal and interest. Most of the pools are adjusted to the prime rate and have no periodic cap and only a few of the pools have a lifetime cap. The adjustability feature along with the superior credit quality of the SBA pool makes this investment an attractive product.

Small Business Administration (SBA) 504 Debentures

These are 10 to 20 year fully amortizing, fixed rate promissory notes secured by equipment and typically a second deed of trust on commercial real estate occupied 51% or more by the borrowing business. These debentures are created under the SBA's 504 program to finance the acquisition of real estate and equipment for businesses or the expansion of an existing facility, thereby creating jobs. The duration and fixed rate characteristics of these bonds may not fit most credit union balance sheets.

United States Agency for International Development (AID) Loans

AID loans are 100% guaranteed by the full faith and credit of the U. S. Government. Loans carry fixed or variable rate coupons and normally have maturities ranging from 9 to 30 years. Ownership is evidenced by individual document packages. Loans are made to assist the development of friendly third world countries with participation from those countries' governments. The full faith and credit guarantee is only for investors that are U. S. Entities.

National Oceanic and Atmospheric Administration (NOAA) Loans

NOAA loans are 100% guaranteed by the full faith and credit of the U. S. Government. Loans carry fixed or variable rate coupons with no minimum or maximum denomination or maturity. Ownership is evidenced by individual document packages. NOAA guarantees funding for the purchase of commercial fishing vessels and related industries.

Overseas Private Investment Corporation (OPIC) Loans

100% guaranteed by the full faith and credit of the U. S. Government. Loans carry fixed or variable rate coupons with normal maturities ranging from 5 to 10 years. OPIC's purpose is to promote economic growth in developing countries through insuring investments against certain political risks and the financing of enterprises through direct loans and/or loan guarantees. Typical loan guarantees range from \$2 million to \$25 million, but can be as large as \$50 million.

Purchasing Government Guaranteed Loans

Credit unions and other depository institutions purchase government guaranteed loans to leverage their equity and staffs diversify their holdings and realize greater yields than comparable securities. They can also use them to match assets to liability re-pricing schedules. The advantages of this program are zero principal and accrued interest risk, secondary market liquidity and almost zero administrative overhead. Loans can be resold as well in an active secondary.

Safety

In his concluding comments under “Supplementary Facts,” a certain NCUA examiner wrote these words: “In the end it appears that the CU placed heavy reliance on the guaranty of USDA to support its decision to purchase. If the CU or lead ever asks the USDA to honor its guarantee and purchase this portion ... the USDA will attempt to find ways to say NO.”

The examiner was incorrect and justifiably retracted his statement. Both SBA and USDA honor their guarantees and credit unions are allowed and encouraged to rely upon that guarantee.

All loans purchased in the SBA and USDA secondary market are guaranteed by the full faith and credit of the U.S Government. This guarantee applies to both principal and accrued interest. The guarantee is irrevocable to the investor.

Government guaranteed loans are rated as a low risk asset. “This is an unconditional guarantee to the investor or registered holder regardless of the actions of the originating lender,” writes the SBA’s counsel in commenting on *51 Comp.Gen 474*, interpreting *Section 5 of the Small Business Act, known as 15 USC 634*.

Starting in 1972, the irrevocable nature of the SBA’s secondary market guarantee has been clearly set forth in the opinions of the Comptroller General of the United States. The Comptroller specifically approved the SBA’s purchase from an innocent secondary holder of an SBA guaranteed loan upon the borrowers’ default, even though the SBA had knowledge of the possibility of negligence, fraud

or misrepresentation on the part of the bank which made the loan. This clear and proven idea of the unconditional guarantee for secondary market purchasers, which applies to USDA guarantees as well, has been responsible for the liquidity of these instruments and their suitability as low risk, highly rated investments.

Credit unions are in fact entitled to rely upon the guarantee. Per Russell Bean, Esq., Securities attorney with Clanahan Beck Bean of Denver, under FINRA rules, these transactions, although they appear on the books as loan participations, are in fact securities because they involve the separation of a loan in a guaranteed (no risk to principal) portion and a risk bearing (originating bank held) portion. And as such they are to be analysed as investments although they are accounted for along with participation loans.

April Dahlager is the USDA B&I program director for Colorado. She 40 years there have been roughly 7 cases of a guarantee being downsized or revoked, and in each case it was fraud or severe malfeasance and in each case it had to do with a primary (originating) holder. Karissa Berks, B&I Director for USDA in Kansas, also confirmed this in December, 2010 during a regional call with the USDA B&I directors for all 50 states. Both she and April, among others, are happy to discuss this with any examiner.

These loans, for both agencies, are made by originating banks or credit unions. The SBA, or USDA, issues a guarantee of principal and accrued interest on the loan. To the originating lender, the guarantee is revocable in event of negligence or malfeasance or fraud. To the secondary market holder, defined as "Holder" in the guarantee agreement, however, the guarantee is irrevocable. Your credit union in these cases is the "holder," and has nothing to do with the origination or servicing of the loan. This is an important and critical distinction and can be overlooked by some examiners. There has never, ever, been an incident of failure by USDA or SBA to honor their guarantee *as to a good faith secondary market holder. And it is for this reason that the FDIC categorizes guaranteed loans as 20% (as opposed to 50% or 100%) risk weighted assets in bank examinations*

To fully drive home the point, most credit union examiners now are aware of what the rules for these investments are on the banking side. SBA and USDA guarantees have the lowest possible risk weight if they are in a pool or pass-through security, and the second lowest possible risk weight as individual guarantees. A bank's risk-based capital ratio, as you know, is computed by dividing its qualifying capital by its weighted risk assets.

Assets given a 100% risk rating, such as commercial loans and consumer installment loans, require an institution to maintain total equity capital (tier 1 and Tier 2 capital) equal to 8% of the asset's book value. So-called riskless assets, having a risk rating of zero (cash, U.S. Government securities), require *no capital held in reserve*.

The risk weights for balance sheet assets are summarized as follows:

-0% risk weight: cash, gold bullion, ***loans guaranteed by the U.S. Government***, balances due from Federal Reserve Banks. *(the regulation has been modified with respect to individual loan guarantees that are, like the loans under consideration here, not inside of a pool. Because the loan-by-loan guarantee extends only to principal and accrued interest, individual loan participations are rated at 29%, not zero).*

-20% risk weight: demand deposits, checks in the process of collection, risk participations in bankers' acceptances and letters of credit, and other short-term claims maturing in one year or less.

-50% risk weight: 1-4 family residential mortgages, whether owner occupied or rented; privately issued mortgage backed securities and municipal revenue bonds.

-100% risk weight: cross-border loans to non-U.S. Borrowers, commercial loans, consumer loans, derivative mortgage backed securities, industrial development bonds, stripped mortgage backed securities, joint ventures, and intangibles such as interest rate contracts, currency swaps, and other derivative financial instruments.”

The FDIC’s 20% risk weighted category, as mentioned, includes loan-by-loan guarantees such as the ones in question. Here is what the FDIC risk weight determination says for the 20% category, see www.fdic.gov.

“This (20% risk weight) category also includes claims on, or portions of claims guaranteed by, U.S. Government-*sponsored* agencies;³⁴ and portions of claims (including repurchase agreements) collateralized by securities issued or guaranteed by OECD central governments, U.S. Government agencies, or U.S. Government-sponsored agencies. Also included in the 20 percent risk category are portions of claims that are conditionally guaranteed by OECD central governments and U.S. Government agencies, as well as portions of local currency claims that are conditionally guaranteed by non-OECD central governments to the extent that the bank has liabilities booked in that currency.³⁵ “

Yield

Yields depend on premiums paid and vary from a spread of 100 BPs to well over 250 BPs over Treasuries. Fixed rate loans trade at yields which offer spreads to a comparable treasury yield. Floating rate loans trade at yields which offer spreads to appropriate short term indices such as 90 Day Treasuries, LIBOR or Prime. Have your broker dealer calculate yield for you at various constant prepayment rates – 6,7,8,9 and 10% CPR. Amortize the premium over the weighted average life on the yield table for the CPR you have selected as reasonable.

Example 1

Consider a typical \$500,000 USDA loan guarantee, floating at 2.75 over Prime, adjusting quarterly, priced at 106, with a 5 year amortization of premium:

Prime Rate	3.250%	
Margin	<u>+2.750%</u>	
Current Gross Rate	6.000%	
Servicing Usually	-0.500%	
Net Coupon to the Credit union:	5.500%	
Cost of Funds Internal:	<u>-0.600%</u>	For 3 Month Assets
Net Spread:	4.900%	
Amortize the Premium:	<u>-1.358%</u>	

(6% Premium amortized over 5 years at a 5 percent discount)

Net Spread after Premium:	3.542%
Net Spread \$	\$17,710.00 (3.542% x \$500,000)
Capital Allocated	\$35,000.00 (7% of \$500,000)
Return on Capital:	50.60%

(In this example, the guaranteed loan, with the full faith and credit of the US Government, delivers a yield of about 30 basis points over Prime, which is 339 basis points over today's 3 month Treasuries, and about 294 basis points over the Credit union's cost of funds, with no real administrative load, no principal and accrued interest risk and no rate cap).

Example 2

Now let's look at a smaller SBA guarantee with the same analysis:

Example \$100,000 SBA loan guarantee, Prime plus 2.750%, 10 year amortization, priced at 108.

Prime Rate	3.250%	
Margin	<u>+2.750%</u>	
Current Gross Rate	6.000%	
Servicing Usually	-1.000%	
SBA Fee Always	<u>-0.675%</u>	
Net Coupon to the Credit union:	4.435%	
Cost of Funds Internal:	<u>-0.600%</u>	For 3 Month Assets
Net Spread after COF	3.725%	

Amortize the Premium: -1.600%
 (8% Premium amortized over 5 years at a 5% discount)

Net Spread after Premium: 2.125%

(Note that If prime stays flat the spread returns to 3.725 after premium burns off in 5 years)

Net Spread \$	\$2,125.00
Capital Allocated	\$7,000.00 (7% x \$100,000)
Return on Capital:	30.36%

(In this example, the guaranteed loan, with the full faith and credit of the US government, , delivers a yield until the premium burns off of about 104 basis points under Prime, but that yield is 197.5 basis points over today's 3 month Treasuries, and about 152.5 basis points over the Credit union's cost of funds for 3 month or shorter liabilities, with no real administrative load, secondary market liquidity, full faith and credit and no rate cap. These smaller SBA loans can diversify your portfolio across the country or can be purchased within your trade area.

SBA Passthrough Securities (Pools)

You can buy an interest in a pool of SBA loans, which is a pass through security, for as little as \$250,000. These pools adjust frequently, are AAA rated, and you can pledge them any time to the Federal Home Loan Bank as collateral for liquidity at 97 cents on the dollar.

SBA pass-through securities, or pools, started in 1984. They are very similar to a residential mortgage pass-through, except that the variable rate pools usually have no rate ceiling. Maturities range from 5 to 25 years. Pools are DTC eligible, which means that you receive delivery electronically just as you do FNMA or GNMA securities. The market size is approximately \$50 billion. They are AAA rated and the question you should ask, before you buy a Fannie Mae, Freddie Mac or Ginnie Mae security, is, “can I get an SBA pool with a better yield, or lower extension risk, or more prepayment protection?” The answer is usually “yes.”

Historically, SBA pools outperform most money market instruments and often offer favorable spreads to comparable treasury and LIBOR yields. The variable rate feature allows upside yield potential should rates rise and maintains wide spreads over other indices should rates fall.

SBA pools carry the “Full Faith and Credit” guarantee of the U.S. Government just like Ginnie Maes. This includes the same unconditional guarantee of timely payment of principal and interest. SBA pass-through securities in the banking world are zero percent risk based capital for insured financial institutions and they are allowable investment for money market funds under SEC Rule 2a-7. They are treated as agency securities in the Examiner’s Guide.

Pool rates are tied to the *Wall Street Journal* Prime Rate or One Month LIBOR +3.00 and adjust monthly or quarterly. The variable rate feature allows credit unions to maintain an attractive spread above their cost of funds. Pools may be matched against short term re-pricing liabilities (deposits) for GAAP management.

The adjustable rate feature of SBA pass-throughs reduces the incentive to refinance, therefore reducing prepayment risk. Most pools have no periodic caps and usually no lifetime caps. The Prime Rate and One Month LIBOR Rate historically increase more quickly and decrease more slowly than other benchmark rates. Prepayment penalties offer protection from prepayment risk.

The investor in a SBA pool owns an interest in a diverse group of SBA loans. Each month, the lender (originator) remits the pro-rata share of the principal and interest payment from the guaranteed portion of the loan to Colson Services Corp., the Fiscal and Transfer Agent (FTA) for the Small Business Administration. Colson Services Corp. then forwards the applicable payment to the SBA pool investor, just like the master servicer does for a residential mortgage-backed security.

Pool maturity date is the 25th of the month following the longest loan maturity. Interests in pools can be purchased in minimum denominations of \$25,000 with additional increments of \$5,000.

The coupon rate on a loan in an SBA 7A POOL is equal to:

- The Rate the borrower is paying, for example 6.000% which is P + 2.75%
- Less 1% Servicing to the Servicer -1.000%
- Less the SBA subsidy fee currently 67.5 BPS -0.675%
- Less the fee to the master servicer, COLSON -0.125%

- Equals the NET COUPON 4.200% which is P+ 0.95%

In a REGULAR pool, all the net coupons are THE SAME ON EVERY LOAN. This is accomplished by taking the higher net coupons and STRIPPING OUT an IO strip so that all the loans have the same NET coupon. Somebody else buys the IO Strip.

In a WAC pool, loans of DIFFERENT coupons are allowed. Coupons can DIFFER up to 75 BPS. The POOL rate adjusts every month as loans pay down or pay off because the weighted average changes.

Pools may yield 60 to 150 basis points over comparable US Treasuries. Individual loan guarantees can be 2 to 4 *times* as high. Pools offer “instant” diversification and, because they are securities, they can easily be pledged. Individual loans are harder to pledge but offer a much more attractive yield and they give your credit union an opportunity to select investments geographically, even in your own field of membership, or with a National focus – and by industry type (NAIC code), and by collateral type (real estate secured, equipment secured, or unsecured). Finally, as we’ve said, pools are securities and belong alongside your bond portfolio. Individual guarantees build the loan portfolio and loan to deposit ratio.

Recommended Due Diligence for Individual Loan Guarantees

Our purpose at IBI credit Union Services is to review and present good quality guaranteed loans which, to the extent we can predict with all available tools, will deliver the yield promised. Before you commit to buy a guarantee, you should do some due diligence to mitigate not the credit risk, which is zero, but the premium risk, so you can evaluate how likely it is that this loan will stay on your books long enough to recapture the premium. IBI Credit Union Services will routinely:

- a. Obtain an updated credit report on the business
- b. Facilitate an independent third party site inspection of the business
- c. Obtain a copy of the appraisal if available.
- d. Review the original credit write-up and analysis
- e. Facilitate a detailed demographic and location analysis for the business
- f. Review the default history for businesses of this type using the SBA’s NAICS data which has 9 years’ history for each SIC code
- g. Prepare a table utilizing the latest Bloomberg® software showing what the yield of this guaranteed loan is at a wide range of constant prepayment rate assumptions. “Constant Prepayment Rate” means the amount of principal prepaid in any one year over and above

normal amortization. If the economy is slowing, CPR increases because more loans default, and the SBA or USDA repurchases loans more quickly. If the economy is improving, CPR decreases because fewer defaults are happening. Currently, the Constant Prepayment Rate as compiled by SBA is between 7% and 8%, and falling. It had been as high as 14% at the height of the recession. The higher the CPR, the shorter the average life. The lower the CPR, the longer the average life of the asset.

- h. Prepare and deliver a synopsis and recommendation for your credit union

While the due diligence is performed for you, your review may take 1-2 hours of staff time.

At purchase, when you receive the closing file, your team needs to:

- a. Review the Loan Guarantee Certificate for completeness
- b. Review the Certificate Number and Loan Number
- c. Review the Assignments of Guarantee and collateral file
- d. Review the Trade Confirmation
- e. Wire funds as called for in the Trade Confirmation. IBI clears through Southwest Securities.

These activities can be done in 1 to 1.5 man-hours per loan. IBI Credit Union Services will of course already have reviewed Items “a” through “d” before sending you the file.

Monthly, the loan statement, which includes all loans purchased with SBA guarantees on one form and USDA guarantees on another, needs to be entered into your accounting system as a “loan serviced by others,” and reconciled with the principal and interest payments which are forwarded directly from the Fiscal and Transfer Agent in the case of SBA loans or from the originating institution in the case of USDA loans. The processing time is the same as any other loan related accounting input as you would do with a participation loan. This is a data entry and quality control function.

Availability of Product

SBA and USDA loans are popular investments and are actively traded nationally through a network of broker/dealer firms including IBI Credit Union Services, a division of Isaak Bond Investments. Purchases are made on a forward commitment basis with settlement to follow, usually within 30 to 90 days. Guaranteed portions come in all sizes with maturities ranging from two to forty years. There are fixed, floating and hybrid loans. Floating loans reset to various indices, including Wall Street Prime, U.S. Treasuries, LIBOR and others. Loans trade from par (100) to premium prices over 110 % of par.

Common Questions and Answers:

How reliable is the guarantee if there’s a problem in the loan file? What’s the credit grade of this asset?

The loan portion you would own is guaranteed by the full faith and credit of the US Government. There is no credit or collateral risk. You are guaranteed not to lose any principal or accrued interest. Secondary market guarantees of USDA and SBA loans are UNCONDITIONAL and IRREVOCABLE. The investor ONLY purchases

the guaranteed portion of the loan. The unguaranteed portion remains with the servicing lender along with the servicing of the loan. Your principal dollars invested are not at risk even if there is a collateral shortfall

Is this a loan or security and can I pledge it?

These loans are booked as purchased in your loan portfolio and increase your loan to deposit ratio. GGL loans are not subject to mark to market accounting under current rules. If you buy a portion of a pool, called an undivided interest, that is a security and goes in the investment portfolio. Pools are pledge able to entities like the Federal Home Loan Bank as collateral for borrowings if you need liquidity. Individual guaranteed loans generally are not pledgeable to the FHLB, but may be pledged as collateral for a line of credit on a case by case basis.

What documentation should I retain with my negotiable instruments?

The Loan Guarantee Certificate is your proof of ownership for a purchased SBA loan. On a USDA loan the Guarantee Certificate includes a Transfer Agreement.

What loss reserves should I set aside for these loans?

GGL loans require ZERO loss reserve and do not count against lending limits or the 12.5% commercial loan cap.

Can I resell the guaranteed loan if I need to for liquidity?

Yes. There is an active secondary market and loans can be resold as needed for cash liquidity. However, prices vary daily. Get to know your SBA-USDA guaranteed loan broker-dealer. It is their job to get bids for you and execute trades when you need to. However, be mindful that sales are subject to gain or loss calculations which may affect your profitability.

The Risks:

As you have no doubt heard, these loans trade at a premium. If a loan defaults or prepays early any unamortized premium will have to be immediately amortized. Hence, you “lose” the unamortized part of the loan defaults early because default results in a repurchase by the USDA or SBA and that’s the same as selling a bond at par for which you paid, say, 106.

To help you evaluate the risk, calculate a breakeven for each loan. IBI Credit Union Services can assist with this. The breakeven point is the point at which your cash flow after cost of funds exceeds the premium you paid for the loan. For example, if you pay a 6% premium for the guarantee and the net coupon is 4.6%, and your cost of funds for 3 months is about 60 basis points (3 month treasuries yield about 15 basis points as I write this), your breakeven point is:

4.60% Net Coupon after Servicing (adjusts every 3 month with no caps)
-.60% Cost of Funds
=4.00% Effective

Premium/Effective = Breakeven, so

BEP = 6.00% / 4.00% = 1.5 years

So, if the loan stays 1.5 or more years, you are ahead of the game and there's not a cash loss for an early prepayment. Moreover, on USDA credits, you (the investor) get to keep the prepayment penalty which is often quite substantial – in event of a voluntary payoff. On SBA deals, the SBA keeps the penalty.

So here in a nutshell is the mindset most successful guaranteed loan investors have: buy government loans that are good quality (proven cash flow, or strong compensating factors, or that are in NAIC codes that have low default rates.) These are more likely to “stick.”

Once you are past the breakeven point, which is easy to estimate, you are in the profit zone. And once the loan stays beyond the time you amortized the premium, your yield increases from the reduced yield (called the Bond Equivalent Yield) that reflects the premium, to the full net coupon on the loan (the rate the borrower is paying, less the SBA fee and servicing, as we discussed earlier).

The asset typically adjusts each quarter as Prime or as LIBOR moves. In other words, the premium is a “drag” on your yield. But once the premium has amortized or burned off, the drag is no longer there and your earnings on the asset in question increase very dramatically.

To amortize the premium:

Remember what we said about CPR, or Constant Prepayment Rate. The best rule of thumb we have heard is to use the current, documented CPR, based on published SBA data, plus 1-2% as a stress factor. So if the CPR nationally is 6, use 8. Then see what the WAL, or Weighted Average Life, is, at an 8% CPR. If the WAL is 7 years, it is sensible to use a 7 year amortization period.

The accounting for premium, as we write this, is to amortize the premium over the life of the asset, in proportion to the amount of principal you are receiving each month.

Some examiners will insist that under GAAP rules, you have to amortize the premium on a 25 year loan over 25 years regardless of what you think the Constant Prepayment Rate or Weighted Average Life is. Under this old fashioned method, when the loan prepays, as it eventually will, you then deduct the remaining unamortized premium as an expense.

We can assist you with the correct Industry accepted calculations.

Servicing is Done For you

You get ONE check each month with loan by loan detail. This saves man-hours, there's little or no administrative cost. This is a self managing asset.

Delivery:

Unlike corporate bonds or stocks or municipals these trade DVP (Delivery Versus Payment)

You receive all documentation prior to delivery, then you agree to terms of Settlement and become the beneficial owner at exchange of funds.

The Regulations

Section 723 (1) (b) (4) of the NCUA Rules and Regulations states that “a loan where a Federal or State agency fully insures repayment, or fully guarantees, repayment, or provides an advance commitment to repurchase in full...” is not a Member Business Loan. This, taken with the treatment of SBA participations in the NCUA Examiners’ Guide, leads us to conclude that the loans need not be underwritten as MBL’s and that the guarantee is for the purpose of making the asset more liquid.

The NCUA Examiners’ Guide does not hold credit unions as holder to the same standards of underwriting as if we were making a new commercial loan because we are not. NOR does the guarantee count against our MBL lending limits.

Instead, the Guide zeroes in on the risk in government guaranteed loan participations, which is NOT the principal and accrued interest, and which is NOT that SBA or USDA will avoid their guarantees as to a secondary market holder such as ourselves. The risk as we have said is PREMIUM RISK, that the loan defaults, or pays off, before the premium is fully amortized.

The National Credit Union Association Examiner Guide, Chapter 12, covers SBA loans as investments. The Guide is wrong in one respect: there is a very active secondary market in these loans and in the SBA pools which many go into.

Here verbatim is what the Guide says:

“Fixed-rate Small Business Association (SBA) guaranteed loans have appealed to some credit unions because of their relatively high yields. SBA also has a variable-rate participation loan, in which the loan rate generally adjusts quarterly and moves with the prime rate, thus reducing the IRR of the security.

However, the lack of an active secondary market for these loans limits their marketability, making them more suitable as a long-term investment than as a liquid asset. Generally, SBA single loans contain more risk than SBA loan pools. Likewise, SBA loan pools that have a small number of loans carry more risk than do pools with larger numbers of SBA loans. In other words, the larger the number of loans in the pool, the more predictable is the pool’s performance and the better its marketability.

SBA loans, whether fixed or variable rate, do not have a consistent average life and SBA can call them for immediate repayment, which could result in a loss if the credit union purchased the SBA at a premium. In addition, the “thin market” (i.e., not an actively traded

secondary market and a limited number of brokers making a primary market in SBAs) restricts marketability of these instruments.

Example: *A credit union purchased a \$100,000, 10 percent, 5-year SBA loan at 105. After one year, the balance of the loan was \$80,000 and the unamortized premium was \$4,000. The borrower repaid the loan in full at this point. Since SBA guarantees repayment only at par, SBA would not reimburse the credit union for the remaining \$4,000 unamortized premium and the credit union must absorb the loss during the current accounting period.*

Credit unions should be aware of the dangers of purchasing SBA loans and other secondary participations at high premiums. However, the decision of whether or not to purchase SBAs remains with the officials.”

About IBI Credit Union Services

IBI Credit Union Services is a division of the venerable firm of Isaak Bond Investments, Inc. Isaak Bond Investments is a 33 year old institutional municipal broker dealer based in Denver. Isaak Bond Investments is a member SIPC and licensee under FINRA. They provide SBA and USDA loans and pools for credit unions and some community banks. Isaak Bond also provides bonds for a number of nationally known, very large municipal bond funds, credit unions, trust departments and institutional investors. Isaak Bond Investments makes a market in taxable municipals, SBA and USDA guarantees, agencies, and rated general obligation and revenue bonds.

About the Author

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In addition to this White Paper, Tim is the author of:

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