HANOVER SECURITIES

SBA Jewels and Pools

Commentary… from the desk of Joel Banes -10/29/2018

From 2008 to 2016, interest rates were consistently low, while SBA prepayment speeds were relatively stable. In that environment, it was expedient to use a “standard” prepayment speed and ignore the use of a “vectored” prepayment speed when projecting potential yield for an SBA Pool. That said, we have always advocated for the benefit of utilizing vectored payment speeds to evaluate SBA Pools.

In October 2017, the SBA changed the way it passes through the embedded principal which exists in seasoned pools to the SBA registered holders. The following will demonstrate why we believe the use of vectored prepayment speeds is even more advisable following this change. To appreciate the difference between SBA prepayment speeds and vectored prepayment speeds, consider the data.

SBA Prepayment Speeds - Sept 2018

	8-11 yr WAM Years 1 thru 4 = 81.8% outstanding $'s		21 + yr WAM Years 1 thru 5 =77.6% outstanding $'s	
Yr.	YTD 9-2017	YTD 9-2018	YTD 9-2017	YTD 9-2018
1	4.3%	4.9%	1.4%	2.3%
2	7.0%	8.4%	4.6%	5.8%
3	12.1%	14.1%	11.0%	14.1%
4	12.7%	17.8%	14.9%	24.3%
5			12.3%	26.2%
10			3.5%	19.9%
11	7.6%	64.3%		

Source: Bloomberg

SBA Vectored Speeds New Pools - Sept 2018

	Sept. 2017	Sept. 2018
8-11 yr WAM	8.2%	9.5%
21 + yr WAM	6.6%	10.4%

In years one through three above, the speeds have increased only slightly from 2017 to 2018. However, the increase in speeds in years 11 and 10, is very large.

Nevertheless, the vectored speeds have only increased modestly. The reason is that the principal balance in years 10 and 11 is so small, the impact one would expect to see in the vectored speed isn't there. This is because vector speeds use the outstanding principal balance to weight each year. While pools aged over 5 years are demonstrating very high CPR's due to the embedded principal being returned to investors following SBA's prepayment amortization change effective in October 2017, the impact on the vector is not nearly as drastic as one would expect.

Today's vector incorporates a combination of brand-new pools under the new rule, pools two to four years old with minimal embedded principal, and seasoned pools with embedded principal and high prepay speeds. Moreover, the new rules substantially minimize the accumulation of embedded principal that has occurred since the inception of SBA pooling. The 20% differential between the longest and shortest maturity in SBA pools is now 5%.

The early life has always been the most important factor investing in premium SBA pools. If one is focused on the higher prepay speeds of older pools they will miss the opportunity to balance out their portfolio with new pools. Bottom line: Employ your vectors!

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