SBA Jewels and Pools

HANOVER SECURITIES

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Issuance of SBA par pools increased from $2 billion in 2017 to more than $4 billion in 2018. The increased supply caused the par coupon to go from Prime less 2.625% (currently 2.625%) to Prime less 2.25% (currently 3%).

Investors in SBA interest-only strips (COOFs) continued to capitalize on COOF purchases. These investors focused on the prepayment speeds of the underlying loans and were not affected by the change the SBA implemented a year ago which inflated pool prepayment speeds[1]. COOFs had no imbedded principal to be passed through. Additionally, some COOF investors chose to employ leverage to enhance their returns.

SBA pool prepayment speeds have increased this past year. Specifically, the rule change mentioned above substantially accelerated prepayment speeds on seasoned pools.

Traditional pool investors, or "program" investors, employed the strategy of investing in portions of multiple pools over a longer timeframe. This strategy maximized loan diversification and it blended in new slower paying pools with seasoned pools that are paying at higher speeds. Furthermore, it tends to insulate investors against changes in the prices of SBA pools by continually blending in new pools at current market prices.

Some traditional investors in SBA pools have stopped investing in this sector following SBA's rule change – they have been hit the hardest by the rule change because they experienced the resulting increased prepayment speeds but not the opportunity to blend in new, slower paying pools at substantially reduced prices.

The implementation of FASB's Current Expected Credit Loss (CECL) starts in January 2019. The booking of expected credit loss under this pronouncement is designed to reduce earnings volatility. This is an enormous change banks will have to adjust to, because in 2020 it will impact every bank's capital significantly.

Increased loan demand has reduced the size of bank investment portfolios. As such, portfolio earnings are down. Moreover, the rise in rates has imbedded loses in many of these portfolios. To top it all off, CECL is here!

The SBA rule change and CECL are both one-time changes that will have a considerable impact on banks across the country. What's your strategy to capitalize on these changes? Let's compare to our strategies.

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[1] Rule change: https://www.federalregister.gov/documents/2017/10/16/2017-22466/changes-to-sba-secondary-market-program