

Growing Pains

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Much has been said about the challenges of selling pools of loans into the capital markets via securitization or other techniques. In our experience, the actual sale is often the least difficult part of the process. The reason is that organizations can draw on the skills of a range of experts who can help with that part of the process. Attorneys are available who can guide organizations through the complexities of securities law; financial consultants offer advice regarding the proper accounting under generally accepted accounting principles and evaluate structuring alternatives; and investment bankers stand ready to market the securities. The belief at our firm is that the process leading up to the sale is often more challenging than the sale itself. What follows is an overview of the skills, resources, and risk management techniques needed to sell pools of loans.

Preparing to Access the Capital Markets

While accessing the capital markets can lower an organization's cost of funds, it also has its own costs and risks. Accumulating a sufficient volume of loans to be able to efficiently access the capital markets puts pressure on an organization's financial resources and organizational infrastructure. It also introduces potential new threats to the firm's well-being, including interest-rate risk and additional challenges managing the balance sheet.

The first step an organization must take to access the capital markets is to build the right team. An organization needs to select attorneys that have extensive experience with asset-backed securities transactions in order to move quickly and efficiently through the numerous challenges associated with securitization-related documentation. In addition, it must select an investment banker that will play the critical roles of first interfacing with the rating agency to determine the optimal deal structure and then selling the notes created from the securitization transaction. In addition, the organization should identify a servicer, backup servicer, custodian, and trustee with capital markets experience.

Because securitization is a sophisticated transaction involving numerous outside experts, organizations will face complex negotiations on fees. Retaining a financial advisor to assist with these negotiations can help ensure transaction costs stay under control.

To effectively manage the accumulation and securitization processes, organizations may have to develop new financial models, or enhance their existing models. For example, in order to estimate the sales proceeds from securitization and the resulting gain on sale, we worked with one of our clients to develop and implement a financial model that produces Public Securities Association (PSA) standard cash flows from a loan-level collateral file. This

allowed our client to aggregate collateral cash flows to determine the optimal securitization structure and perform stress tests under various loss and prepayment scenarios.

By being able to model alternative securitization structures relatively quickly, our client was able to evaluate credit-enhancement alternatives. For example, they wanted to determine if using bond insurance would compress the spread required by the investors enough to pay for the cost of the insurance. In our client's case, they concluded that a senior/subordinated structure would result in less overall cost.

Organizations may also have to enhance their existing financial reporting. In our experience, many organizations do not carefully monitor the loans in their pipelines. We believe careful monitoring of loans in the pipeline is critical in order to minimize accumulation and interest-rate risk. For example, we have worked with our clients to develop systems to track the progress of the loans in the pipeline so that they know when the loans are likely to close and ensure they will have adequate financial resources in place to fund it.

Developing the Financial Wherewithal to Accumulate Pools

Our clients often lack the internal financial resources to be able to accumulate pools of loans for sale. As a result, they enter into short-term borrowing arrangements with commercial or investment banks. The organization closes a loan and then borrows against the loan's value using a revolving line of credit. Often referred to as a warehouse line, the line of credit is repaid after the sale is executed. In general, a warehouse lender will not advance 100 percent of the loan amount. In our experience, the advance rate depends on the type of underlying loan and ranges from 75 to 98 percent. A typical advance rate for commercial loans is 80 percent. The organization accumulating the loans finances the difference, or "haircut," with its own cash.

The warehouse lines of credit generally include financial covenants that specify minimum net worth and limit the line of credit amount to a specified multiple of net worth – generally five or six times. Thus, an organization planning to accumulate \$100 million of loans for sale would need \$20 million of its own liquidity to finance a 20 percent haircut. It would also need \$16.7 million of net worth to support the \$100 million line, assuming the leverage ratio was six to one.

Thus, the accumulation of loans for a securitization can rapidly deplete liquidity as an organization funds the haircut. In addition, growing the balance sheet to accumulate the loans can strain the financial covenants contained in the organization's warehouse agreement and other financial contracts.

Telling Your Story to Investors and Rating Agencies

We note that an organization that wants to access the capital markets needs systems that can provide data on the performance of loans originated by the organization, including detailed information on historical default, recovery, loss, and delinquencies. This performance

information is required by the rating agencies to help assess risk. Without this information, the investment bankers will not have any support for their discussions with the rating agencies on expected performance. This will most likely result in the rating agency making extremely conservative guesses as to the expected performance of the collateral and much less favorable securitization execution. In addition, historical prepayment speeds are needed to estimate the average lives of the securities and set pricing benchmarks. [For more detail on data issues, see Mary Tingerthal's article of this issue.]

Managing The Risks

When an organization enters the world of using capital market investments, it is introduced to new risks. Three leading risks are loan pricing, interest-rate risk, and risks around managing a balance sheet.

Securitization adds complexity to loan pricing and organizations often have to develop new pricing models to match their securitization exit strategy. The securitization model scenario results can be used to develop loan pricing models that are in sync with the organization's expected securitization proceeds and gain on sale. Loan pricing should include the forecasted interest expense on the securities, expected future losses, costs to originate a loan, securitization transaction expenses, credit enhancement expenses, the required rate of return for subordinate retained interest positions, and the organization's required spread or margin of return.

The accumulation of long-term fixed-rate loans for a sale results in substantial interest rate risk because even relatively small increases in market interest rates can have a relatively large effect on the value of the loan because of its long duration. Depending on the type of loan, for every market movement of one percent the value of the loan changes by four to eight percent.

Organizations can mitigate interest-rate risk by developing and implementing an interest-rate risk management, or hedging program, designed to protect against changes in market interest rates. There are myriad potential hedges in the marketplace and the selection of the hedge that is right for an organization depends on the organization's overall hedging philosophy. One of our clients, for example, buys insurance for protection from a disaster by purchasing out-of-the-money interest rate caps. If market interest rates increase past the cap, our client receives payments from the hedge counterparty. If rates fall or rise, but not past the cap, the cap will expire without value to our client.

Another client hedges to protect the spread on the loans it originates and the projected gain from the sale of the loan. To do this, the client shorts U.S. Treasury securities futures with durations comparable to the underlying loans. If market interest rates increase, the hedge increases in value, offsetting the loss on the underlying loans. If, however, market rates decrease, the organization's projected gain on sale increases and its hedge positions decrease in value.

As another example, our clients allow customers to lock-in the rate on their loan before closing. We work with these clients to develop processes and programs to ensure that data on these commitments is accumulated at least daily in order for them to be able to adjust their hedge positions. Thus, our clients will have gains in their hedge positions to offset losses they would incur by funding loans at a loss if market interest rates have risen subsequent to their issuing a commitment to purchase the loan at a specified rate.

One of the keys to a successful hedging program is the quality of the information used to make the hedging decision. We have worked with clients to develop daily position and mark-to-market reports to ensure they have the information they need to make good hedging decisions, to forecast liquidity needs, and to facilitate proper financial accounting and reporting. (We note that marking the hedge to market is straightforward, as the hedge instruments trade daily in the capital markets, while marking the loans held for sale to market is more of a “art form,” which requires making estimated guesses.)

Finally, accumulating loans for sale can cause an organization’s balance sheet to swell and the organization to begin to bump up against the financial covenant limitations of its various debt agreements. To improve monitoring of these covenants and facilitate communication with its lenders, we have worked with clients to upgrade their financial forecasting capabilities so that they can reforecast expected results on a rolling twelve-month basis, including reforecasting of covenant compliance.

Retaining subordinate bonds arising from the securitization can create asset/liability management challenges. We have worked with organizations to forecast the timing of the estimated cash flow to be received from the subordinated positions in order to ensure our clients have sufficient long-term financial resources to be able to hold them.

Securitization also presents financial accounting and reporting challenges. In fact, the proper accounting for securitization has figured prominently in the recent requirements issued by the Financial Accounting Standards Board (SFAS’s # 155 and #156) and requirements that are apt to significantly affect the proper accounting and reporting for these sales is pending (exposure draft to amend SFAS #140).

Going Forward: Strategies For Growth

Asset-backed securitization represents a powerful financial tool for the community development industry. From its relatively modest beginnings in the 1970s, the asset-backed securities marketplace has grown substantially and trillions of dollars of such securities are now sold each year. Nevertheless, accumulating and securitizing loans is a complex process. To be successful, organizations must ensure that they have sufficient financial resources to be able to undertake the transaction; that they properly manage interest-rate risk during the accumulation period; and that they have the proper financial infrastructure in place to manage the process. At the Federal Reserve’s securitization conference, two themes emerged that we thought were responsive to these challenges: the importance of collaborative network structures, and the need for training for CDFIs in the complexities of preparing these transactions.

We believe the complexities and challenges of securitization can be met best through collaboration. We are currently working with the Housing Partnership Network (HPN) and a group of nonprofit financial intermediaries to explore the feasibility of forming a conduit to accumulate charter school loans for sale into the secondary market. We are also working with HPN and a second group of financial intermediaries to explore the formation of a conduit to accumulate and sell single family residential mortgage loans. We believe conduits are an efficient way to accumulate loans in order to get to the scale required for a securitization, to manage the complexities of the process, and to spread the overhead costs related to the effort.

We started this article with the observation that the trickiest part of the securitization process is often the process leading up to the sale, including the process of acquiring or developing the finance skills necessary to engineer these transactions. We believe that a targeted series of trainings on these skills for CDFIs would be valuable to the industry, and could play an important role in increasing the number of organizations ready for the capital markets. A series of such training sessions might include:

- A session on building financial infrastructure (tracking loans, decreasing cycle times, developing systems to manage liquidity, determining the effect of accumulation on asset/liability management, securing and negotiating a warehouse line of credit) in order to be able to efficiently and more safely accumulate loans.
- A session on interest rate risk management that would show how to develop and implement hedges (swaps, caps, futures, etc.) to mitigate interest rate risk as loans are accumulated for eventual sale.
- A session on loan pricing – how to price loans based on the expected securitization execution (subordination levels and anticipated spread by ratings level); expected prepayment, expected default, expected loss severity, and required return.
- A session on the basics of securitization including: assembling the team and their roles; forms of credit enhancement and the relative advantages and disadvantages of each type; dealing with the rating agencies and bond insurers; the importance of servicing; and the roles of the trustee, master servicer and custodian, etc.

While the prospect of pooling and securitizing loans can be daunting, the number of lenders doing it successfully is growing, and the organizations and finance experts that can assist in the process are numerous. With the right combination of experience and expertise, access to the capital markets can become a key part of the funding strategy for community development organizations.

Douglas Winn is president of Wilary Winn, a financial consulting firm that provides advice regarding asset-backed securitization, mortgage banking and interest rate risk management to organizations located across the country, including for profit and nonprofit financial intermediaries, banks and credit unions. Its nonprofit clients include Community Reinvestment Fund, Low Income Investment Fund, Housing Partnership Securities, Housing Partnership Network, and NCB Capital Impact.