The incredible shrinking net interest margin problem that plagues most community banks at the moment can in large part be reduced to a cause-and-effect analysis. The cause is too few high-quality loans available at yields that produce a fair return to the lender. The effects are many: low returns on assets, delinquency and loan loss reserve issues (and by extension, capital issues), and even asset-liability concerns. We can also mention loss of market share and increased cross-selling by competitors.

There is good news on the loan horizon. Partly due to credit disruption (or a very rational market correction, depending on one’s point of view), community banks can purchase high-quality loans, often within their market footprints, at yields that in many cases exceed their own retail pricing.

Th e opportunity

High-quality loans of all types, including residential mortgage loans and commercial real estate loans, are available at attractive yields. Mortgage sellers that relied on securitizations or conduits in the past have a significant amount of seasoned, performing collateral on their books available for sale. Jumbo mortgages, in particular, experienced spread widening over the last year and are available at levels that provide a significant pickup in comparison to agency securities.

Many institutions are looking for investment alternatives for large cash positions (not a great investment in this market) due to deposit growth, prepayments in their securities portfolio and new capital infusions, including TARP funds. Many community banks have purchased loan pools to improve net interest margins, with yields on agency securities and cash equivalents at historic lows. Institutions can also be selective on the product type as there are 15- and 30-year jumbos as well as hybrid adjustable-rate mortgages (3/1s through 10/1s) available.

Many mortgage sellers are larger institutions that prefer to retain servicing. As a result, buyers don’t need a servicing platform to manage the purchased loans. Also, gone are the days of all-or-none trades where buyers had to buy the bad with the good.

In today’s market, buyers can create subsets—typically $5 million or larger—of larger pools and formulate a pool that matches their specific preferences. Buyers have included de novo institutions looking to deploy capital faster than they could organically, institutions with low loan demand and declining margins, and community banks with excess liquidity due to deposit growth.

Full disclosure

The mortgage-purchasing process in today’s market is very buyer-friendly. Investors have the opportunity to perform a loan-level review and select loans that meet their specific credit preferences—including FICO scores, loan-to-values and debt-to-income ratios—as well as documentation type, geographic location and term. Once loans are selected, buyers can conduct credit due diligence where they review the credit file and update property values—obviously important in the current market. (Many loan buyers elect to stay in their market footprint, where they know trends in property values.)
Any loans not passing credit due diligence can be excluded, and the purchase funds only acceptable credits. Buyers end up with a pool of loans that meet their underwriting guidelines and yield requirements. The ability to manage credit risk combined with compelling yields make loans an attractive asset class in today’s market.

**ALCO Strategies**

Asset-liability management has led some institutions to become loan buyers. Some TARP recipients have reinvested a portion into whole loans to better cover the cost of capital. Asset-sensitive banks have used 15- and 30-year fixed rate loans to extend the duration of their balance sheet. Liability-sensitive banks have used ARMs to shorten duration. In addition, loans are not marked to market, unlike securities, and are easily financed or pledgeable with the Federal Home Loan Banks.

**Don’t Take Our Word**

Bob Becotte is the chief financial officer of The Cooperative Bank in Roslindale, Mass., a $260 million-asset mutual association. His community bank recently purchased a package of jumbo mortgages at yields higher than it was advertising locally.

Becotte says The Cooperative Bank’s loan demand typically involves 30-year conforming fixed rates, which the bank then sells to Fannie Mae and Freddie Mac.

“With conforming rates so low, we don’t want to be stuck with fixed rates at these levels,” he says. “We also had been sitting on excess cash, which isn’t paying us anything either.”

However, purchasing loans is a new activity for The Cooperative Bank. “We’ve been able to buy loans in our market at rates higher than we’ve advertised,” Becotte explains. “And, we can basically cherry-pick the products that fit us from an A/L position, by focusing on 15-year fixed and hybrid ARMs.

“We consider this a safe product, and we feel we’re adequately compensated on the yield side.”

So, if mortgage loans in your community bank’s backyard that fit your credit criteria and your yield bogeys are of interest to you, they can probably be produced in attractive block sizes and in relatively short order. ICBA Securities’ loan trading department is open for business.

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**Your Expert Resource**

ICBA Securities’ loan trading professionals are available to consult with your community bank’s lending staff to identify opportunities in purchasing high-quality loans. Visit icbasecurities.com or contact your sales rep for more details.