Now and Later
SBA 7(a) pools built for today and tomorrow
By Jim Reber

How many times have you heard a sentence beginning with that phrase regarding your community bank? I bet that’s the second most common query next to the banal “how’s the weather?” Let us count the ways it’s been used:

» Examiner: “What if all of your non-core deposits left tomorrow?”
» Borrower: “What if I pledge my golf clubs as additional collateral?”
» Auditor: “What if the market value of your held-to-maturity bonds declines?”
» Depositor: “What if I take out a CD for 13 months instead of 12?”
» Investor: “What if you were to buy my 10 shares at three times book?”

What if you could buy a full faith and credit investment that has an adjustable rate feature, which yields roughly the same as a five-year government bond? Such is the current opportunity with Small Business Administration 7(a) pools.

Uncle Sam has your back. For those with risk-based capital concerns, those who feel they have sufficient exposure to government-sponsored enterprise (GSE) debt or those who simply want to diversify their credit exposures, SBAs could well be the answer. As an investment sector, it is one of only three labels that are considered direct obligations of the U.S. government (the others being Treasury obligations and Ginnie Mae mortgage-backed securities).

The floating rate pools (also known as 7(a)s) have become quite popular with community banks over the last three years. As proof, over 44 percent of the banks that use Vining Sparks for their bond accounting own at least one SBA as of March 31, 2012. Five years earlier, that number was under 20 percent. Part of the reason is the credit quality, but there are other niceties as well. Liquidity and pledgeability are nearly as good as for the GSEs, so they can be easily sold or financed.

More critically, as absolute yields on the short end of the interest rate curve have been compressed to near zero for more than three years while banks have been flush with cash, it’s been a constant struggle to produce some type of return from money-market instruments. Here’s where the fun really begins.

Get yields out on the curve.
Before launching into current yield analysis, some explanation is necessary. SBA 7(a)s are unique in that they float based on Prime, and therefore Fed Funds. Virtually all have very short reset periods of either 30 days or 90 days, and, importantly, they have no caps, either periodic or lifetime.

This results in market prices that are very stable, including (and especially during) rising-rate environments. It is the upshot of being indexed to a money-market rate with no caps. In this way, many portfolio managers feel they serve as a perfect counter-weight to the long-duration, fixed-rate items they currently own.

It’s not too difficult to achieve a 1.00 percent yield with these floaters in the current environment. That is partly a function of the amount of premium risk you’re comfortable absorbing (more on that later). What I hasten to point out is that their yield is now about in line with a five-year Treasury note. So floating rate pools certainly keep you in the game, even if Fed Funds stay put for two more years.

Improve performance. The only real risk an investor takes on with a 7(a) is prepayment risk. That is always the case with bonds that amortize but especially so when the purchase prices are 108, 110 or even 112. How can a risk-averse community banker cope with this?

For one, pay attention to the pool size and the pool age. An SBA pool can have a few as four loans, although most have many more than that. A pool with 30 loans, evenly distributed, greatly disperses the prepayment risk. Also, longer-term pools (those with original terms of over 15 years) have prepayment penalties for the first three years.

Prepayments on the 7(a) universe have declined for seven consecutive years as the borrowers have essentially been refinanced into record-low borrowing costs. One day, when Fed Funds and Prime begin adjusting upwards, prepayment speeds will likely pick up. But in the meantime, SBAs seem poised to perform very well for the next few quarters, or even years.

What if your community bank had a segment of its investment portfolio in SBA 7(a) pools?
for executives wondering how regulatory changes will impact their bottom line

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