



## U.S. Government Guaranteed Loans *A Full Faith & Credit Investment*

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Depository institutions purchase government guaranteed loans to leverage their equity and staff, diversify their holdings and realize greater yields than comparable securities. They can also use them to match assets to liability repricing schedules. The advantages of this program are:

- Guaranteed by the full faith and credit of the U.S. Government
- 20% Risk Based Capital
- Higher yields than comparable securities
- Ease of acquisition and management
- Wide variety of types of loans
- Liquidity

### **Safety**

All loans purchased in the SBA and USDA secondary market are guaranteed by the full faith and credit of the U.S. Government. This guarantee applies to both principal and interest. The guarantee is irrevocable to the investor. Government guaranteed loans are rated 20% Risk Based Capital by most bank regulators.

### **Yield**

Yields depend on premiums paid and vary from a spread of 100 BPs to well over 200 BPs. Fixed rate loans trade at yields which offer spreads to a comparable treasury yield. Floating rate loans trade at yields which offer spreads to appropriate short term indices such as 90 day Treasuries, LIBOR or Prime.

### **Acquisition Costs**

The ease of acquisition of this product and its low maintenance costs are noteworthy advantages. There are no hidden costs, attorney fees, appraisals, liquidation costs or site inspections to be considered. The only time consumed in implementing a Guaranteed Loan Program is at purchase and during a monthly entry of principal and interest payments which are forwarded directly from the Fiscal and Transfer Agent in the case of SBA loans or from the originating bank in the case of USDA loans.

### **Availability of Product**

SBA and USDA loans are actively traded nationally through a network of broker/dealer firms. Purchases are made on a forward commitment basis with settlement to follow, usually within 30 to 90 days. Guaranteed portions come in all sizes with maturities ranging from two to forty years. There are fixed, floating and hybrid loans. Floating loans reset to various indices, including Wall Street Prime, U.S. Treasuries, LIBOR and others. Loans trade from par (100) to premium prices over 110.

## **Liquidity**

Guaranteed loans trade in an active secondary market and have excellent liquidity. Investors can receive live quotes and lock in a sales price over the phone. Loans that are current in payments can usually settle within 14 days.

## **Administration of Loan Portfolios**

The ease of administration of guaranteed loans is one of the attractive features of this program. Investors receive a monthly statement and remittance and must merely make a data entry for each loan. When setting up these loans there are two issues that investors must account for, delay days and amortization of any premium paid. There is a delay between the borrowers due date and the date of remittance to the investor. This delay should be accounted for to prevent the appearance of delinquency. The other issue is the amortization of premium. Upon settlement of each loan, investors should establish an amortization schedule for the write down of any premium paid. Investors should consult their auditors to determine an appropriate amortization schedule.

## **Risk**

It is readily apparent that since both principal and interest on these loans are guaranteed, the primary risk associated with these loans is from any premium paid. Guaranteed loans trade from Par to over 110 with the vast majority of product offered at premiums. The return of premium is not guaranteed. Early payoff of principal, whether because of default or prepayment, results in a lower yield than the yield to maturity.

## **Management of Prepayment Risk**

Experienced guaranteed loan investors have developed strategies to manage premium risk that have survived the test of time. The prepayments of SBA pools have been measured for over 20 years. From this data investors can make assumptions about the prepayment of guaranteed loans. Prepayments have been very stable over time and have a very low correlation to changes in interest rates. These prepayments have averaged from 10 to 16 CPR. By proper diversification of the purchases in a portfolio, investors can expect to duplicate these results. Establishment of a target amount for each individual loan in the portfolio can help limit the premium risk. Investors should also limit the dollar amount of premium paid on each loan to an acceptable level should that loan prepay early. Many investors also choose to accelerate the amortization of any premium paid over a 3 to 5 year period to quickly eliminate the premium risk.

## **Default**

In the event of default, the investor will ultimately receive all principal and accrued interest. In the case of SBA loans, the fiscal and transfer agent will initiate the default process after the loan is 60 days in arrears. In the case of USDA loans, the investor makes demands to the servicing bank after the loan is 60 days in arrears. Interest is accrued to settlement date rather than claim date. This assures the investor of never having a non earning asset in the portfolio.

## **Summary**

With their safety, ease of acquisition and management, and their enhanced yields, US Government Guaranteed loans offer institutional investors an excellent alternative to more traditional investments. Your Coastal Securities representative can customize a program to assemble a portfolio over time to match your needs.

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