



Secondary Market Update: SBA 7(a) Loans

April 2019

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Today's Agenda

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Originating and Selling SBA 7(a) Loans

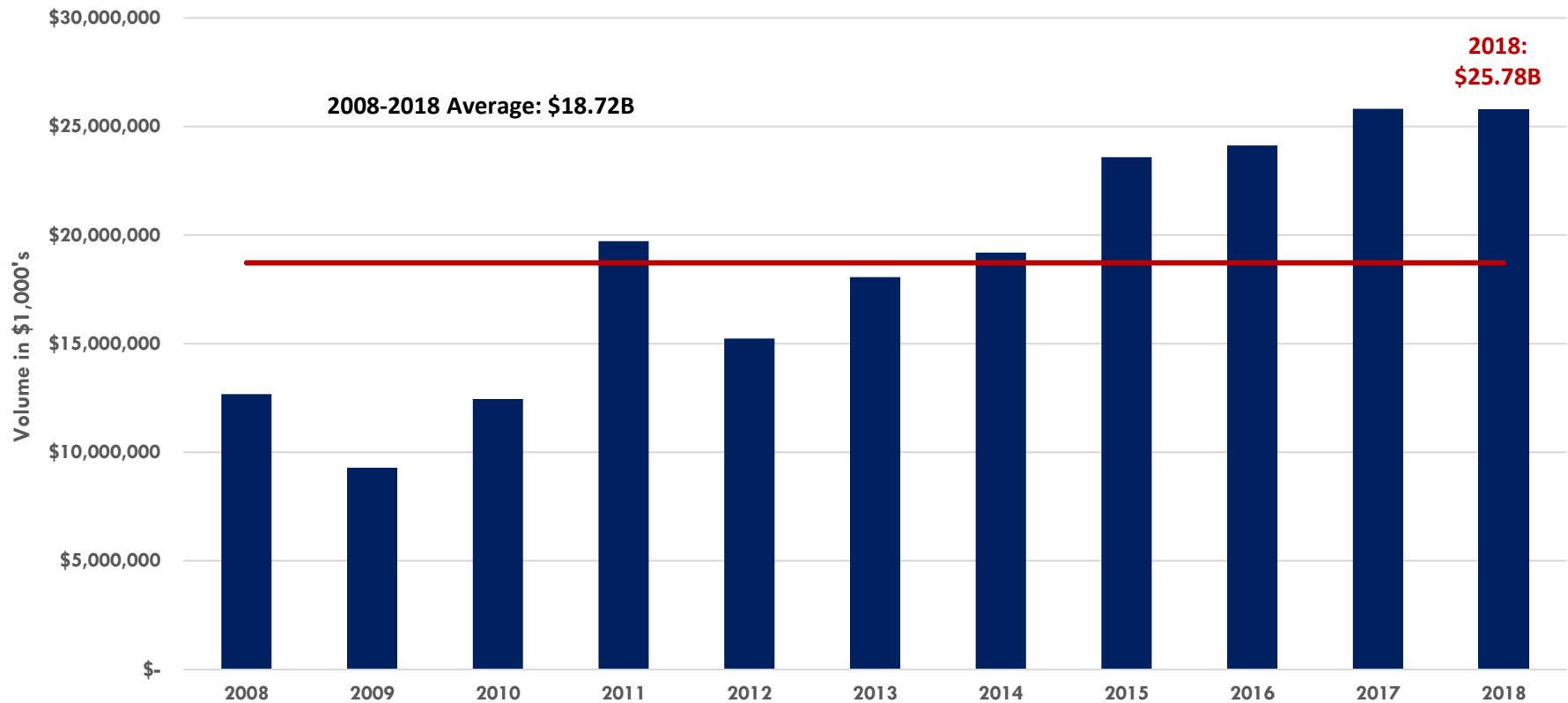
- *Introduction to the secondary market*
 - *To Hold or to Sell...*
 - *What drives premium levels?*
- *Role of the Lender, Dealer & FTA*
- *Recent pricing trends*
- *Sample Pricing*
- *Gain on Sale Accounting (ASC 860)*

Introduction to the Secondary Market

Annual Gross SBA 7(a) Loan Approvals

(Note SBA Fiscal Year of Oct. 1 – Sep. 30)

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SBA 7(a) Secondary Market

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- The guaranteed portions of SBA 7(a) loans are traded on an established secondary market
- Loans are either “bundled” with other similar loans and securitized into 7(a) pools or sold individually to an investor
- Investor base is primarily other regulated depository institutions in need of high quality assets
- Several regional Broker/Dealers involved to facilitate the transfer
- Guaranteed portions typically trade at a considerable premium

Hold or Sell?

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Hold

- Earn full rate on entire loan balance over life of the loan
- Capital and lending capacity tied up in the principal portion of guaranteed piece

Sell

- Generate liquidity – re-lend those dollars in community
- Upfront income (premium)
- Earn a servicing fee on the guaranteed portion
- Give up long-term earnings for up-front income

Why Sell to the Secondary Market?

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- Win business in competitive projects
- Immediate liquidity
 - Leverage your lending capacity
- Increased earnings
 - Servicing Income
 - Premium income

Servicing Income

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- **SBA requires lender to hold at least 1% for loans sold at a premium**
 - Can hold less if sold at par or a discount
- Collected during the life of the loan
 - Collected on guaranteed portion sold
- Retain for on-going guarantee fee
- Smaller servicing fee – greater premium
- Larger servicing fee – smaller premium

Premium Income

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- One time source of income
 - Collected at time of loan sale
 - Can be anywhere from 1% to over 15%, depending on note terms

Note: Review ASC 860 for accounting guidance on the sale of financial assets

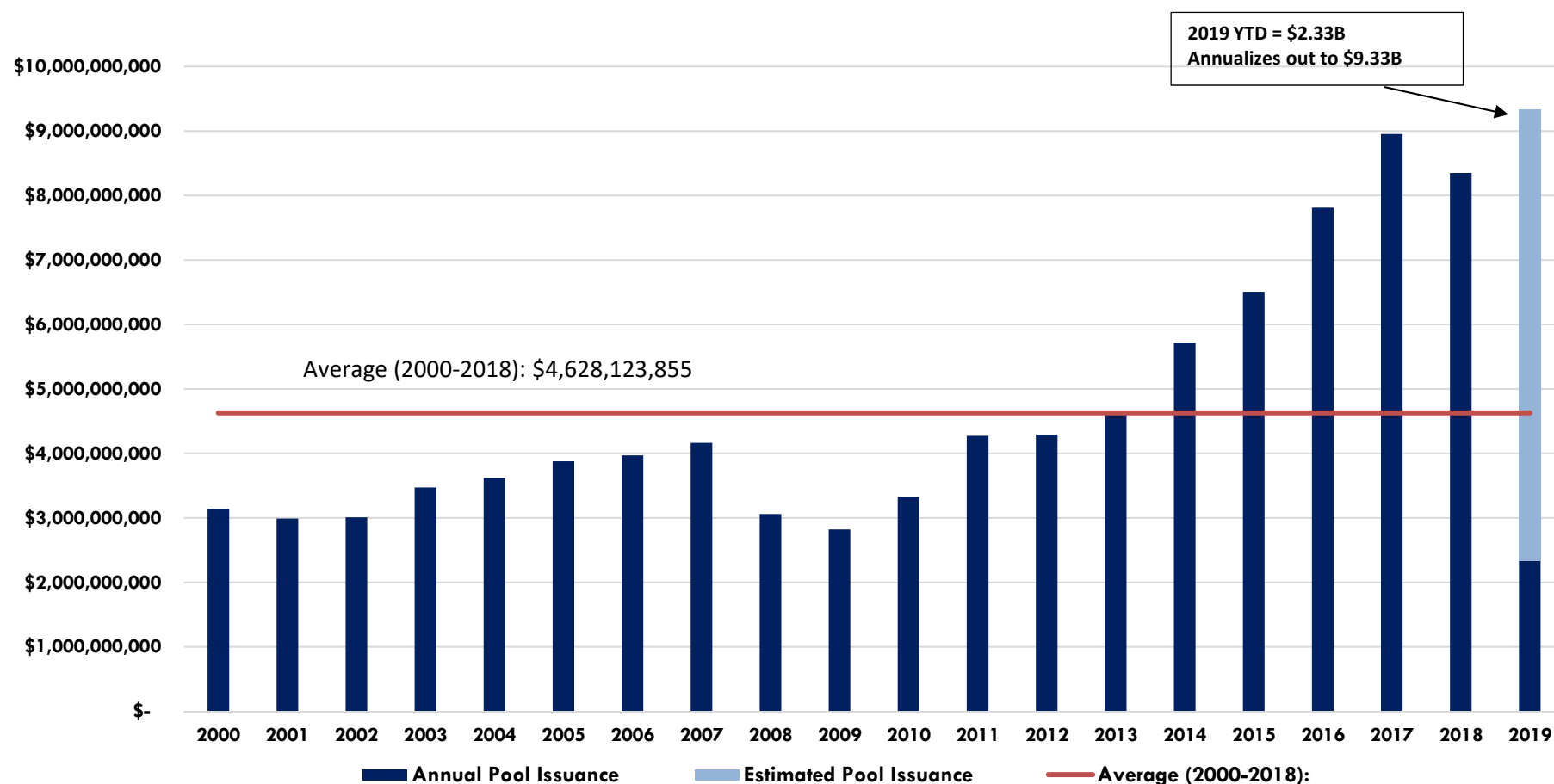
Premium Drivers

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- Pool eligible structures command highest premium
 - Brand new!
 - Calendar quarterly adj
 - Indexed to prime
 - 10yr or 25yr maturity
 - Longer maturities and higher coupons command higher premiums
- Loans under \$2MM in size more liquid
- **HOWEVER...** A very active market exists for non-pool eligible loans (1yr, 3yr, 5yr, fixed rates, etc.)

Total SBA 7(a) Pool Issuance by Year

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WAM Buckets

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- Pools are categorized into “WAM Buckets” based on the underlying loan term and collateral type:

WAM Bucket	All Issuance % of Total	2018 % of Total
<8	5.91%	0.762%
8 to 11	30.30%	41.87%
11 to 16	4.60%	2.89%
16 to 21	4.68%	2.22%
21+	54.51%	52.26%
8-11 and 21+	84.81%	94.13%

- The pool production among differing WAM buckets will vary from year to year. A vast majority of pool issuance each year will fall in either the 21+ year or the 8-11 year WAM buckets. These two WAM buckets represent 85% of all pools issued since program inception and 94% of recent issuance.

What Loans Can Be Sold?

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- SBA 7(a) program loans
 - Standard 7(a)
 - SBA Veteran Advantage
 - International Trade
 - SBAExpress Loans
- Use of Proceeds*
 - Working Capital
 - Equipment
 - Real Estate

*Cannot sell revolving credit lines

The SBA Secondary Market

Bid Sheet

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- SBA GP Number
- Loan Guaranteed Balance
- Gross Coupon
- Net Coupon
- Fixed or adjustable rate
- Payment frequency
- Coupon adjustment frequency
- Prepayment Penalty
- Original dated date of loan
- Maturity date of loan
- Caps/Floors

The SBA Secondary Market

Bid Process & Good Delivery

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- Loan bids are typically only executable the moment they are conveyed
- Bidder should communicate the nature of the bid
 - Indication or Market Bid
 - Expiration/Lock Period
 - Assumptions being made
- Once a price is agreed upon, seller and buyer are contractually obligated to sell and buy the loan at that level
- Price typically “locked” for 30-45 days for Good Delivery Process
- “Good Delivery” is the receipt of all documents in good order and ready for settlement
 - Loan terms agree with those known at the time of bid
 - Loan fully disbursed and current
 - All official transfer documents completed correctly

Role of the Lender, Dealer, and FTA

The SBA Secondary Market

The Role of the Lending Bank

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■ Lending Bank

- retains customer relationship as they continue to service their SBA loans
- sells the loan to FTN Financial at a predetermined coupon and price

■ Customer

- will not know that the loan has been sold into the secondary market

The SBA Secondary Market

The Role of the Lending Bank

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- Books premium received from the sale of the loan as income
 - In accordance with Generally Accepted Accounting Principles as defined in *ASC 860*
- Retains total (gross) coupon from the borrower on the unsold, unguaranteed portion
- Retains servicing fee on the sold portion of the loan
 - at least 1% if loan is sold at a premium

The SBA Secondary Market

The Role of the Broker/Dealer

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- Broker/Dealer purchases SBA loans in an active negotiated secondary market
- The lending bank forwards required loan transfer documentation to FTN Financial for review
- B/D forwards documentation to the registered fiscal and transfer agent for the SBA loan to be placed on a registered loan certificate
- B/D will either:
 - sell the individual loan to an investor
 - or combine the loan with other similar SBA loans into an SBA pool through the fiscal and transfer agent

The SBA Secondary Market

The Fiscal & Transfer Agent

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- Lending bank will forward, on a monthly basis, the pro-rata share of the borrower's principal and interest payments to the FTA who remits these payments to the ultimate investor
- Modification requests must be submitted to the Agency/FTA. FTA will seek holder concurrence before approving any note modification.

Recent Pricing Trends

Drivers of 2018 pricing shift

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There are several factors that contributed – in our mind in increasing importance:

- Pooling changes that narrowed the maturities of eligible collateral (SBA Rule Change)
- Excess principal distribution (SBA Rule Change)
- Increase in refinancing activity

Drivers of 2018 pricing shift

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Pooling changes that narrowed the maturities of eligible collateral

- Effective October 1, 2017, the SBA reduced the allowable difference between the shortest and longest loan in a pool

Structure Type	Prior Allowance	10/1 and Forward Allowance
WAC Pools	Shortest loan maturity must be at least 76% of the longest loan	Shortest loan maturity must be at least 94% of the longest loan
Regular Pools	Shortest loan maturity must be at least 80% of the longest loan	Shortest loan maturity must be at least 94% of the longest loan

- Effective October 1, 2018, the SBA further tightened the maturity bands from the previous 94% to 95%. This change removed another 2-3 months variability from a pool's underlying loans.

Drivers of 2018 pricing shift

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Pooling changes that narrowed the maturities of eligible collateral

- Maturities of loans and the timing of sale more critical under the new rule
- Waiting 3 months to sell a 10 year loan could mean 2-3 points in premium!

Drivers of 2018 pricing shift

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Excess principal distribution

- The SBA published a notice in the Federal Register on October 16th that impacted the way excess principal within SBA7(a) pools is paid out to investors.
- Under the new guidelines, all excess principal held in pools created between 10/1/2004 to 9/1/2017, was reallocated to the unpaid loans in that pool on a pro-rata basis, regardless of its origin.
- Has increased prepayment speeds on affected pools – predominately seasoned pools.

Drivers of 2018 pricing shift

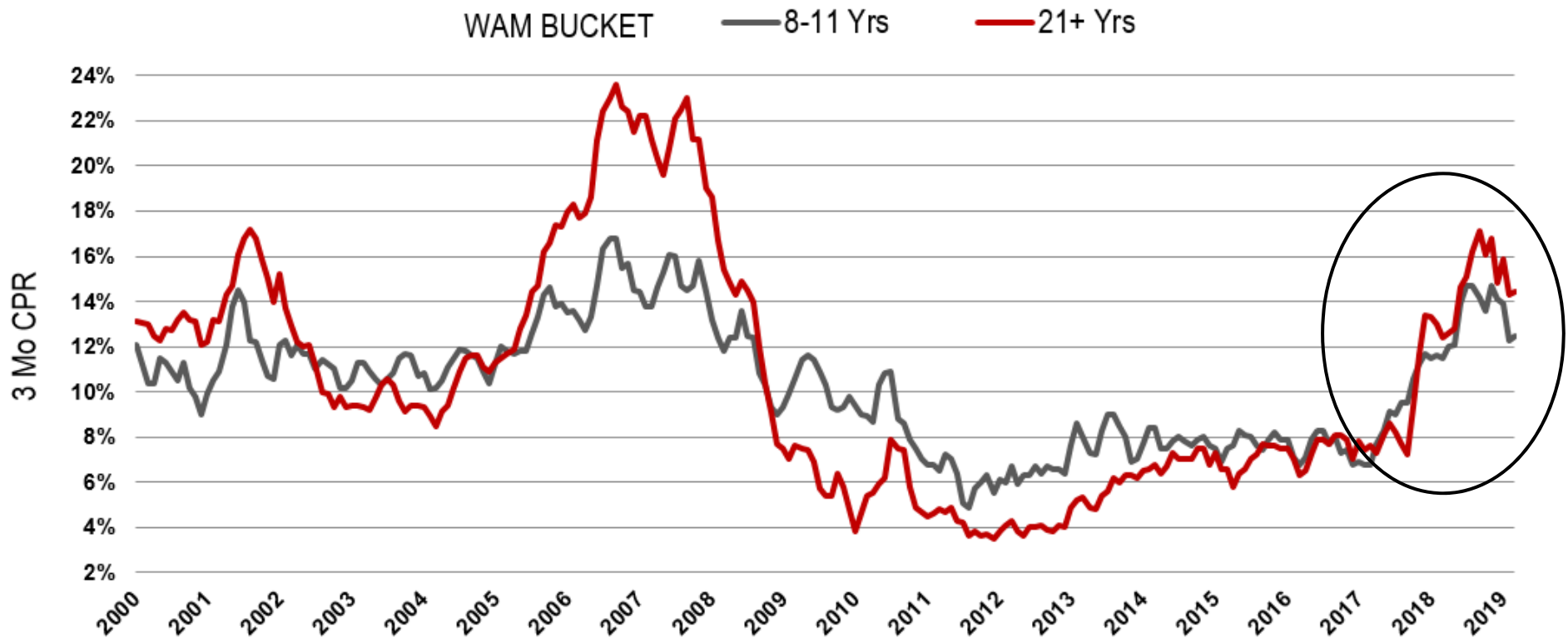
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- ❑ 2008-2017
 - ❑ Nearly 10 years of historic low speeds
 - ❑ 6-10CPR range
- ❑ Q4 2017 – Q4 2018
 - ❑ Speeds trended upward driven primarily by voluntary component
- ❑ Equipment/Working Capital (2008-2018 issuance)
 - ❑ 3M CPRs = 14.1%; 6M CPRs = 15.1%
- ❑ Real Estate (2008-2018 issuance)
 - ❑ 3M CPRs = 14.8%; 6M CPRs = 17.4%

Three Month Prepayment Speeds

Higher % = Pain for Investors

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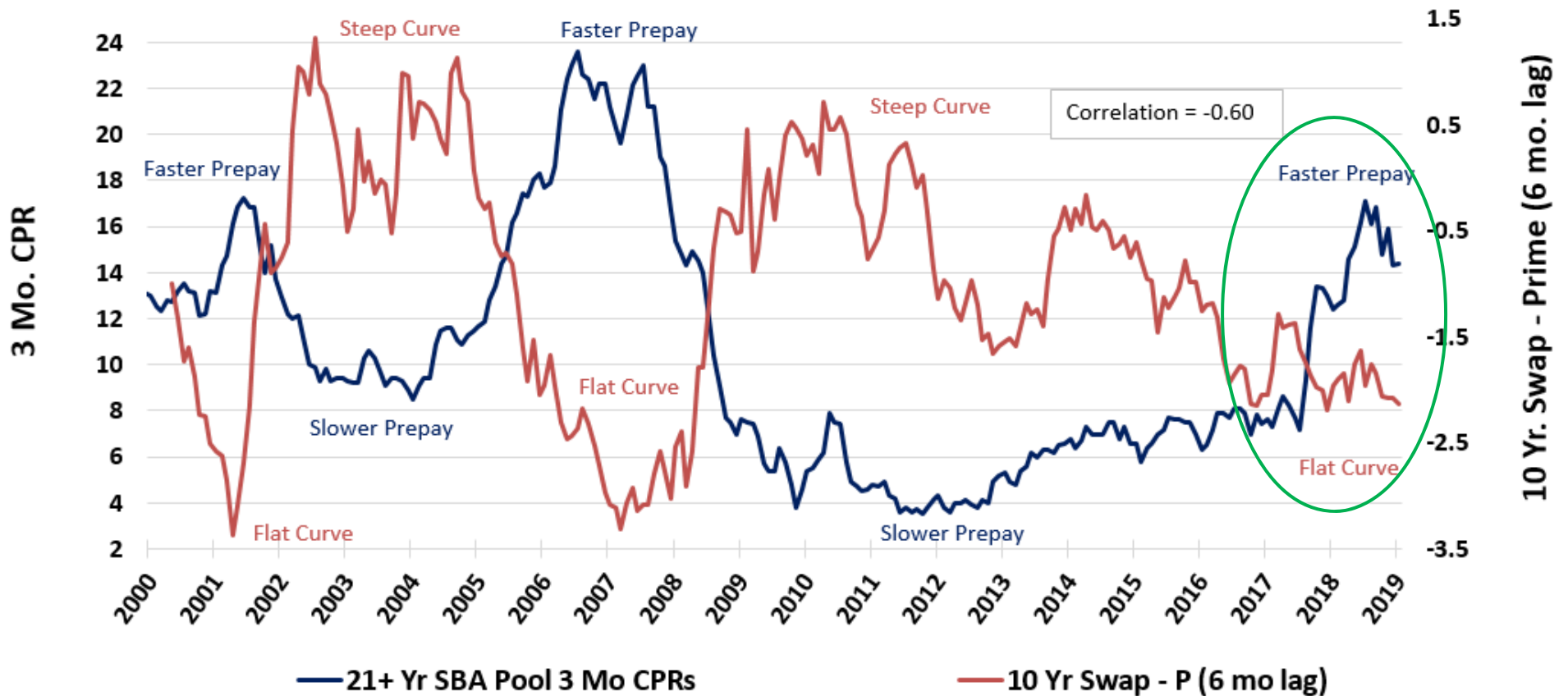


Yield Curve Shape & SBA Prepayments

Flatter = Faster, Steeper = Slower

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21+ Year Real Estate Pools: Prepayments vs. 10 Year Swap Rate - Prime (6 mo. lag)



Drivers of 2018 pricing shift

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Summary of Drivers impacting pricing shift:

- The SBA rule changes that narrowed the maturities of eligible collateral
 - Long run this is a good thing but temporarily it did lead to some pricing inefficiencies as certain loans became ineligible for pooling
- Nearly all seasoned SBA loan pools have been affected by the forced distribution of excess pool principal
- Recent pick up in prepayment activity driven primarily by refinancing
 - Flattening curve, increases in prime rate & loosening credit markets creating refi incentive

YTD 2019

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- Loan pricing rebounded some in the 4th quarter of 2018
 - Initially due to a strengthened demand for the I/O strip
 - Government shutdown significantly impacted supply in Q1 2019
- Full coupon 25yr loans trading in the \$114's
- Full coupon 10yr loans in the \$110's
- Factors that could impact loan pricing going forward
 - Investor demand for SBA securities
 - Changes to supply levels
 - Yield curve shape/prepay speeds

Pricing for illustrative purposes only and subject to change based on market conditions.

Par Pool Issuance

60% of 2018 & YTD 2019 pools issued with par/discount coupons

Par Pool Origination by Year



FTN Financial Economic Forecast: 3/2019

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Economic Forecast

March 8, 2019

Growth indicators	2018		2019				2020				2018	2019	2020	
	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4				
Interest rates, end of quarter and end of year														
Federal funds rate (top of range)	2.25%	2.50%	2.50%	2.50%	2.25%	2.25%	2.25%	2.50%	2.50%	2.50%	2.50%	2.50%	2.25%	2.50%
Interest paid on excess reserves	2.20%	2.40%	2.40%	2.40%	2.15%	2.15%	2.15%	2.40%	2.40%	2.40%	2.40%	2.40%	2.15%	2.40%
Fed Primary Credit (Discount Rate)	2.75%	3.00%	3.00%	3.00%	2.75%	2.75%	2.75%	3.00%	3.00%	3.00%	3.00%	3.00%	2.75%	3.00%
3-month LIBOR	2.40%	2.81%	2.60%	2.60%	2.35%	2.35%	2.35%	2.60%	2.60%	2.60%	2.60%	2.60%	2.35%	2.60%
3-mo Treasury bills	2.19%	2.45%	2.39%	2.35%	2.20%	2.20%	2.24%	2.40%	2.40%	2.40%	2.40%	2.40%	2.20%	2.40%
2-yr Treasury notes	2.81%	2.48%	2.53%	2.50%	2.27%	2.30%	2.40%	2.50%	2.60%	2.65%	2.65%	2.65%	2.30%	2.65%
5-yr Treasury notes	2.94%	2.51%	2.50%	2.49%	2.37%	2.45%	2.50%	2.55%	2.65%	2.70%	2.70%	2.70%	2.45%	2.70%
10-yr Treasury notes	3.05%	2.69%	2.70%	2.66%	2.63%	2.60%	2.65%	2.75%	2.80%	2.80%	2.80%	2.80%	2.60%	2.80%
30-yr Treasury bonds	3.19%	3.02%	3.09%	3.05%	3.00%	2.92%	2.90%	2.85%	2.90%	2.95%	2.95%	2.95%	2.92%	2.95%
Prime bank rate	5.25%	5.50%	5.50%	5.50%	5.25%	5.25%	5.25%	5.50%	5.50%	5.50%	5.50%	5.50%	5.25%	5.50%
Avg. fixed mortgage rate	4.99%	4.84%	4.85%	4.81%	4.78%	4.75%	4.80%	4.90%	4.95%	4.95%	4.95%	4.95%	4.75%	4.95%

- Economic growth peaked in Q2 2018
- Low inflation, lower market rates, Fed funds rate cut by the 3rd quarter
- Curve slightly steepening throughout 2019

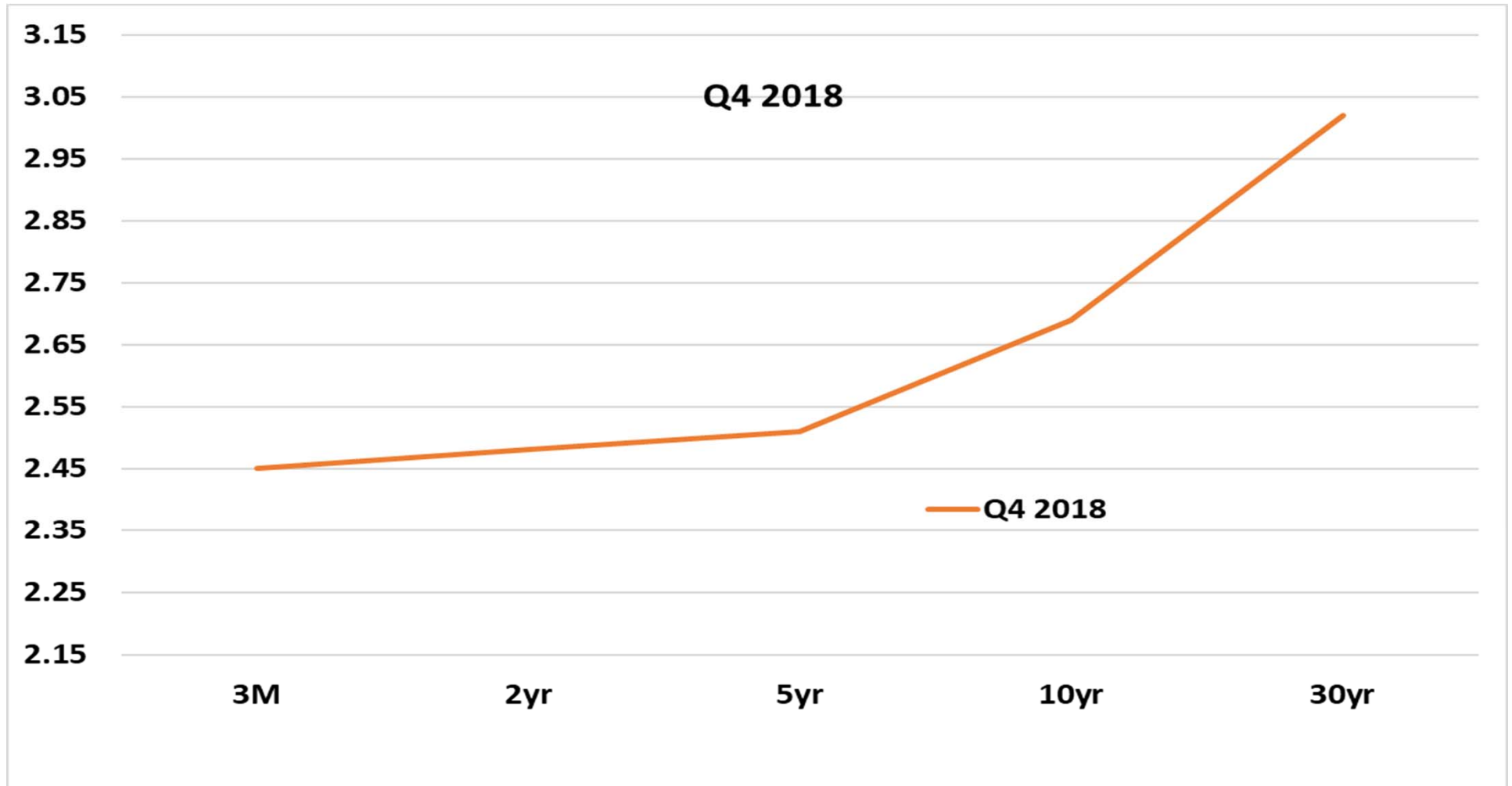


Source: FTN Financial

FTN Financial Economic Forecast: 3/2019

2019 Yield Curve Forecast

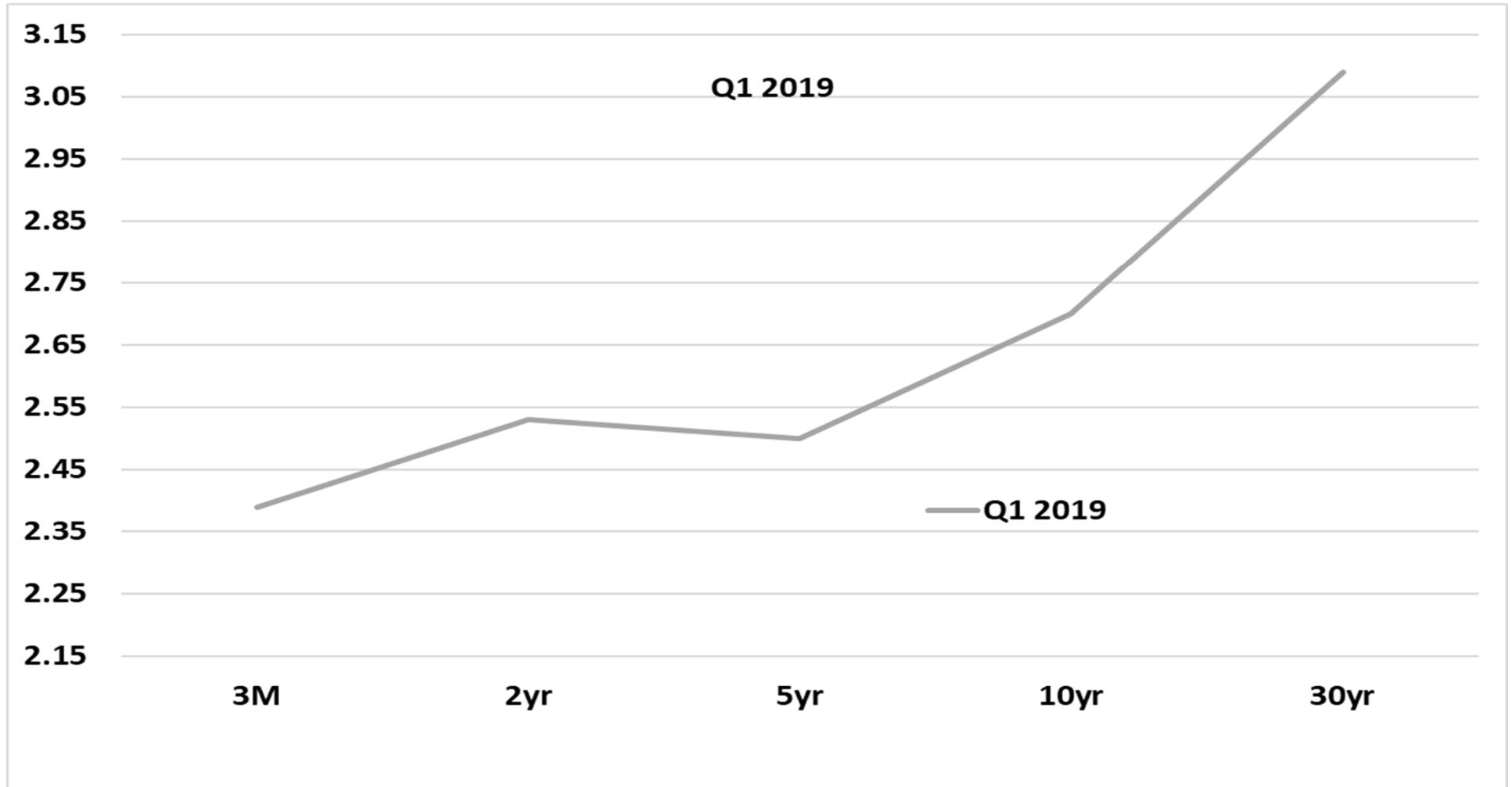
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FTN Financial Economic Forecast: 3/2019

2019 Yield Curve Forecast

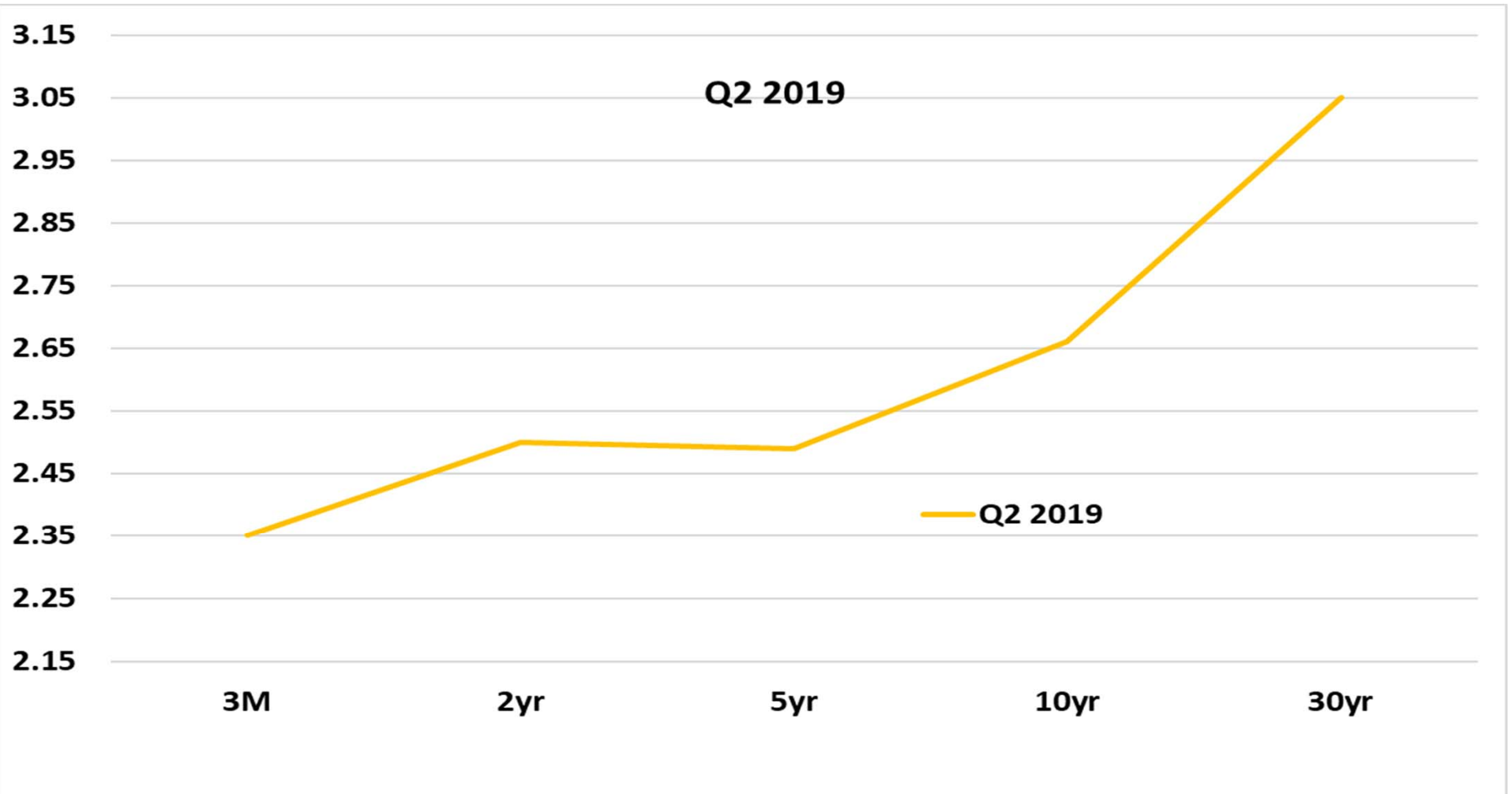
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FTN Financial Economic Forecast: 3/2019

2019 Yield Curve Forecast

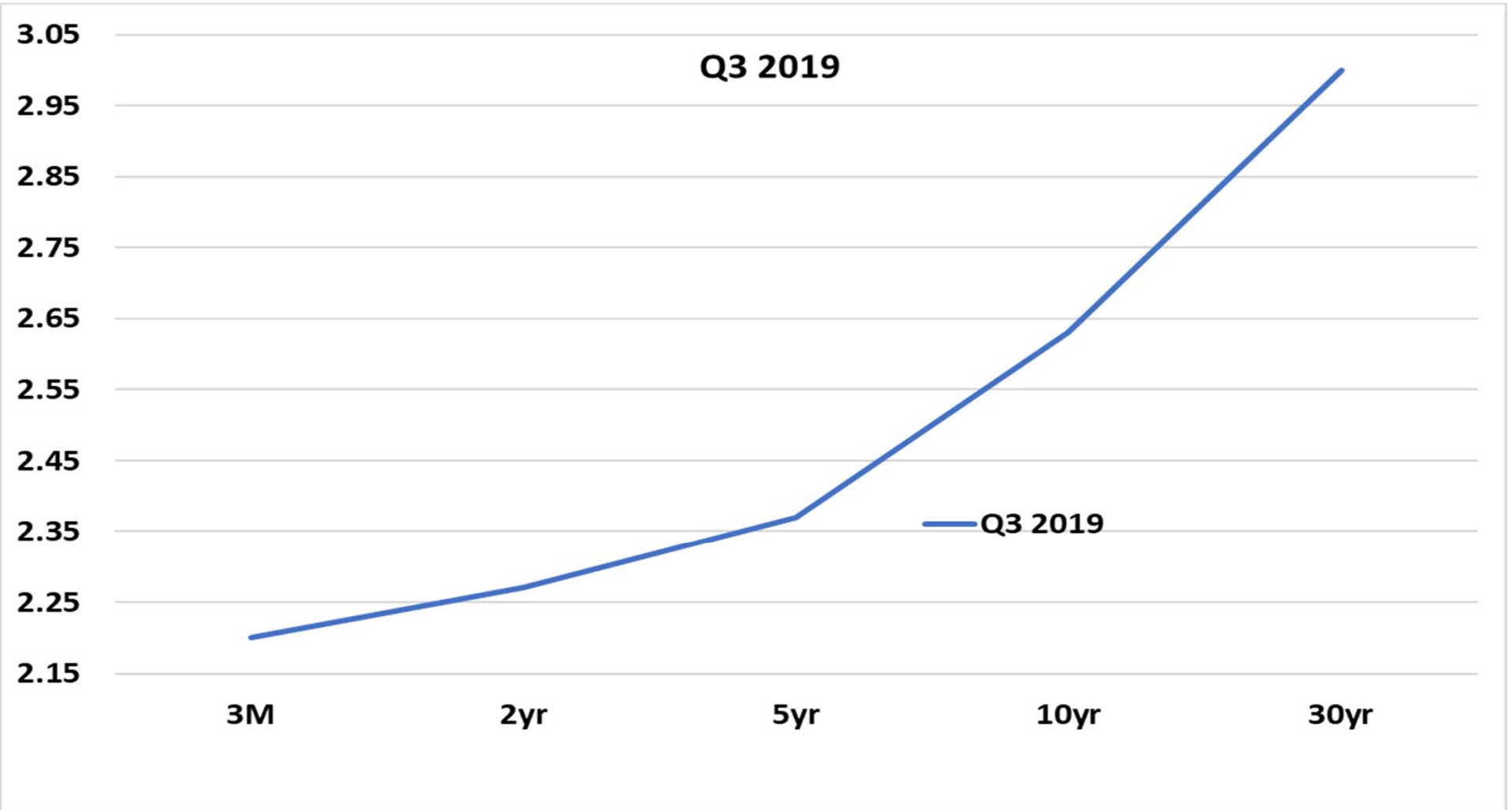
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FTN Financial Economic Forecast: 3/2019

2019 Yield Curve Forecast

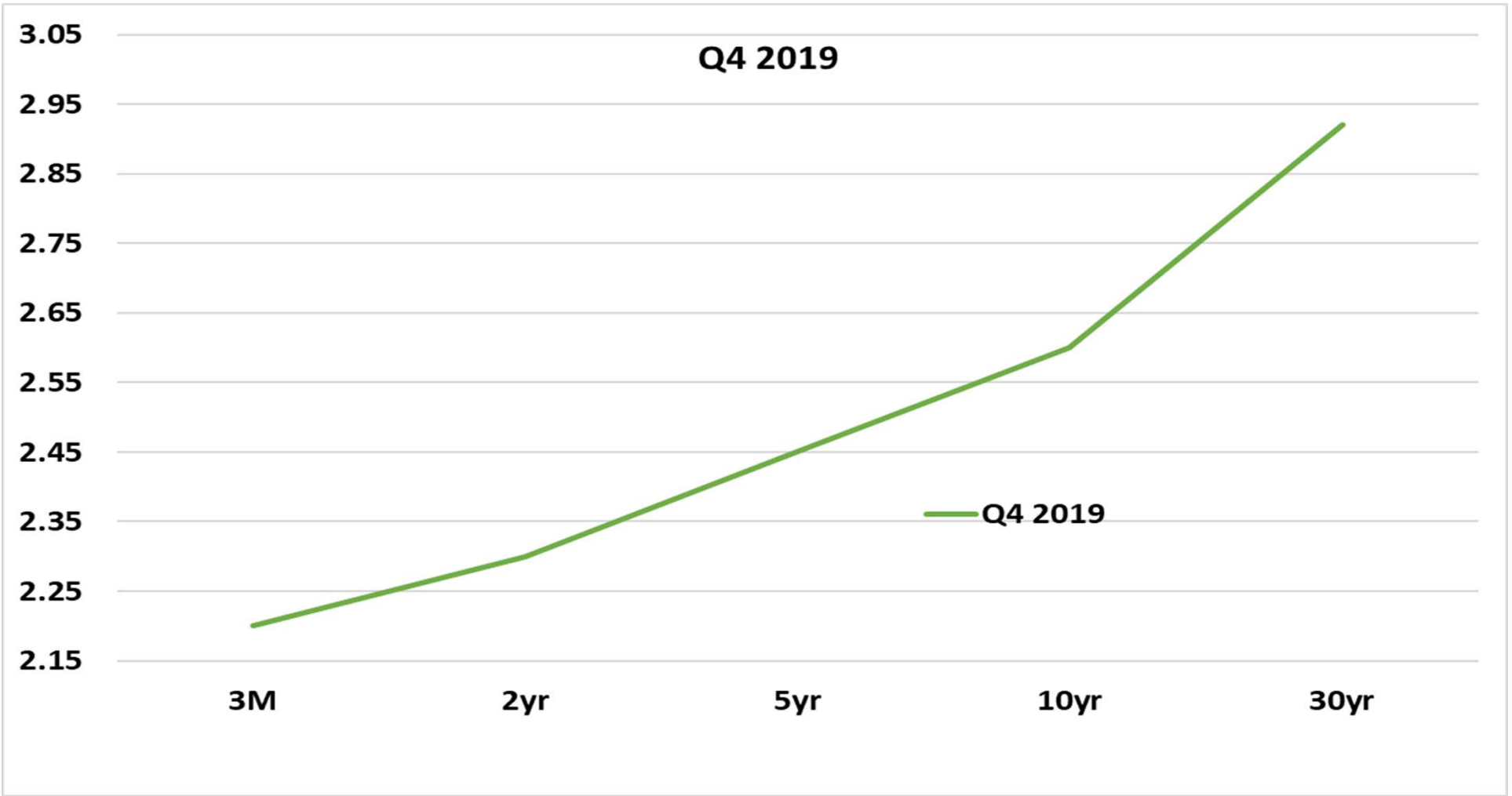
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FTN Financial Economic Forecast: 3/2019

2019 Yield Curve Forecast

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Defaults Increase in Next Cycle?

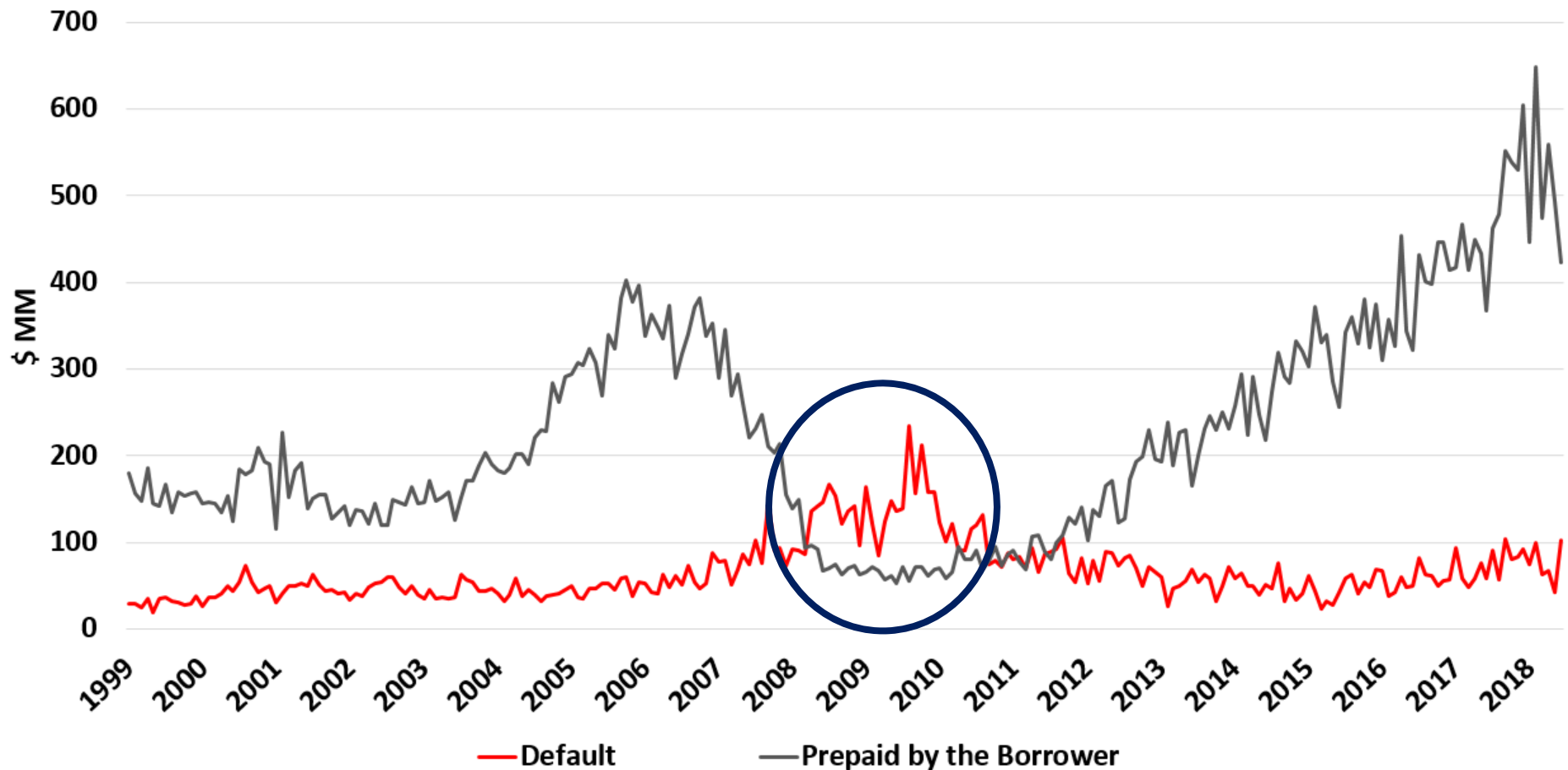
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- ❑ Do we expect defaults to increase as economic activity slows? Yes.
 - ❑ No signs of that occurring yet, though there is an observed lag
 - ❑ Uptick in defaults in Feb. was related to govt shutdown & delayed action on Jan. defaults
- ❑ Defaults historically minor contributor to total prepaids
- ❑ Increase in defaults typically more than offset by drop in refinancing activity
 - ❑ Economic downturn historically accompanied by steepening yield curve (removes incentive) and tightening credit (removes ability)

Defaults Increase in Next Cycle?

SBA 7(a) Loan Market: Voluntary vs. Involuntary Prepayments in Dollars

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Hold or Sell?

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- Many in the 7(a) lending community have questioned whether or not to sell into current market levels
- For those that are doing so with the anticipation that pricing will soon revert back to pre-2018 levels, we believe that there are forces at work that could prevent that from occurring
 - Permanent rule changes
 - Impact of aging!
 - Current prepayment cycle

We believe these factors driving pricing are here to stay for a while and are not transient in nature...

Sample Pricing

The SBA Secondary Market

Loan Sale Analysis – 25 Yr P+2.75 Quarterly Adjust

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Loan Sale Analysis - Variable Rate SBA Loan

Loan Details

Transaction Details

Loan Name or Number:	Main Street Pizza	Gross Rate:	8.250%
Originated:	3/28/2019	Retained Servicing Fee:	1.000%
Matures:	3/28/2044	Net Margin:	1.750%
P&I Payment Frequency:	Monthly	Net Rate:	7.250%
Rate Adjustment Frequency:	Quarterly	Sale Price:	\$ 114.000
Gross Cap (Leave Blank if N/A):		Net Premium Percentage:	12.000%
Gross Floor (Leave Blank if N/A):			
Current Index Rate:	5.50%		
Margin:	2.750%		
Current Gross Rate:	8.250%		
Current Balance:	\$ 1,000,000		
Guaranteed Percentage:	75%		
Unguaranteed Percentage:	25%		

The SBA Secondary Market

Loan Sale Analysis – 25 Yr P+2.75 Quarterly Adj.

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Guaranteed Portion Sold to FTN: <i>(Current Loan Balance x Guaranteed Percentage)</i>	\$	750,000
Unguaranteed Portion Held By Lender (Invested Funds): <i>(Current Loan Balance x Unguaranteed Percentage)</i>	\$	250,000
Premium Forwarded to the SBA: <i>(Guaranteed Portion x 1/2 of Premium over 110)</i>	\$	15,000
Premium Earned on Sale: <i>(Guaranteed Portion x Premium Percentage)</i>	\$	90,000
Servicing Fee Income on Guaranteed Portion Sold: <i>(Guaranteed Portion x Retained Servicing Fee)</i>	\$	7,500
Interest Earned on Unguaranteed Portion Held: <i>(Unguaranteed Portion Held By Lender x Gross Rate)</i>	\$	20,625
Year 1 Return: <i>(Premium + Servicing + Interest)</i>	\$	118,125
Years 2 and Following Return: <i>(Servicing + Interest)</i>	\$	28,125

Return On Invested Funds

Year 1:

47.250%

Years 2 and Following:

11.250%

Assumptions:

Constant Prime Rate

0% CPR (No amortization of loan balance in excess of scheduled amortization).

All premium taken in Year 1 (may not be allowable under ASC 860 Accounting for Sale of Financial Assets).

Per SBA regulations, if sale price exceeds \$110, seller receives only 1/2 of the amount greater than 110 with the other 1/2 paid to the SBA.



Sale price for illustrative purposes only.

The SBA Secondary Market

Loan Sale Analysis – 25 yr P+2.75 Annual Adjust

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Loan Sale Analysis - Variable Rate SBA Loan

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P&I Payment Frequency:	Monthly	Net Rate:	7.250%
Rate Adjustment Frequency:	Annual	Sale Price:	\$ 110,000
Gross Cap (Leave Blank if N/A):		Net Premium Percentage:	10.000%
Gross Floor (Leave Blank if N/A):			
Current Index Rate:	5.50%		
Margin:	2.750%		
Current Gross Rate	8.250%		
Current Balance:	\$ 1,000,000		
Guaranteed Percentage:	75%		
Unguaranteed Percentage:	25%		

The SBA Secondary Market

Loan Sale Analysis – 25 yr P+2.75 Annual Adjust

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Year 1 Return: <i>(Premium + Servicing + Interest)</i>	\$	103,125
Years 2 and Following Return: <i>(Servicing + Interest)</i>	\$	28,125

Return On Invested Funds

Year 1:

41.250%

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11.250%

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ASC 860 Gain on Sale Accounting

The SBA Secondary Market

Gain on Sale Accounting

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- ASC 860 – sale of financial assets
 - Seller/Originator must carry on it's balance sheet any retained interest in the sale of a financial asset at fair market value (FMV)

Three Components in a SBA loan sale:

1. The guaranteed portion (portion being sold)
2. The unguaranteed portion (portion retained)
3. The servicing asset (servicing fee on sold portion)

The SBA Secondary Market

Gain on Sale Accounting

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1. Guaranteed Portion

- FMV is sale price to secondary market

2. Unguaranteed Portion

- FMV is estimated by discounting expected cash flows over estimated life
 - Average life @ 12% CPR
- Discount factor determined by lending institution
- Typically valued at a slight discount (discount rate higher than borrower rate)
- Discount accreted over estimated life of loan

The SBA Secondary Market

Gain on Sale Accounting

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3. Servicing Asset*

- FMV is the net present value of expected servicing income stream discounted over expected life
- Discount factor is estimated yield for similar investments
- Servicing asset amortized over estimated life of the loan

** Servicing retained above 1% is generally considered to be in excess of the contractual servicing rate and could create an interest-only strip which would have to be carried at FMV*

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