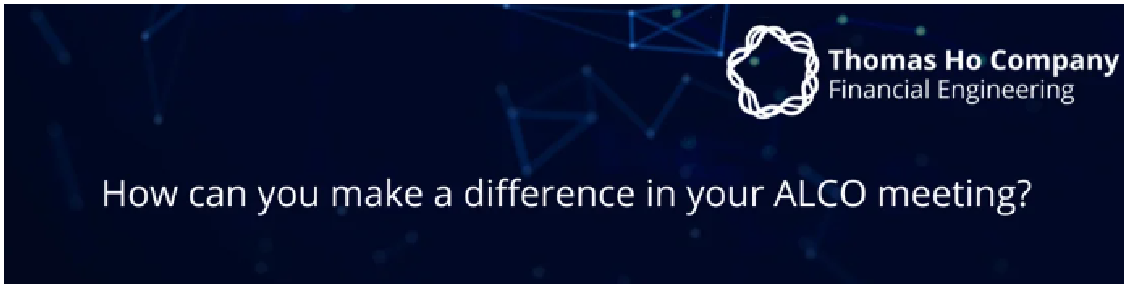

Weekly Post Series 2023 #34

Consider Secondary Market Loan Sales When Preparing Your CFP

Silicon Valley Bank's collapse has heightened the urgency for institutions to review their Contingency Funding Plan (CFP). Liquidity planning is always important, but for those with large balances of uninsured deposits, it has taken on a sense of urgency given recent events. The rapid increase in interest rates, causing steep mark-to-market declines in asset values, and increasing deposit outflows has exacerbated the problem. Having a robust CFP to protect against a run-on-the-bank scenario will be a focus of regulatory exams for the foreseeable future. It is also important to consider whether your institution could withstand a fast-moving social media attack or a sharp increase in competitor rates.

In this post, we will discuss a potential solution, but we first want to review the requirements of a solid CFP.

SVB's Contingency Funding Plan Report

In regards to SVB, we used CALL data, calibrated to Thomas Ho Company's database to calculate an implied CFP report. In a previous post, we highlighted the rapid balance sheet deterioration of SVB's interest rate risk and product profitability throughout 2022 and showed how a basic trend analysis based on call data could have raised red flags well before the bank's demise.

Below is SVB's implied CFP report for Q4 2022. The results show that SVB failed their Capacity Coverage Ratio, Liquidity to Asset Ratio, Wholesale Funding Coverage, and Coverage after LCAP Initialization in the SVB-Crisis scenario.

Liquidity scenario		Base Case	Liquidity Moderate	Liquidity Severe	SVB-Crisis
Dynamic Gap	Total Sources of Funds (A)	24,695,355	18,369,265	6,860,360	(20,890,111)
	Total Uses of Funds (B)	10,584,512	9,972,311	8,760,397	9,188,440
	Projected Cash Flow (C = A -B)	14,110,843	8,396,954	(1,900,038)	(30,078,551)
	Liquidity Coverage Ratio (A/B)	2.33	1.84	0.78	(2.27)
	Total Secondary Sources (D)	87,136,752	79,816,187	55,734,573	40,427,019
	Capacity Coverage Ratio (D / C)	N/A	N/A	29.33	1.34
	Total Liquidity (C+D)	101,247,595	88,213,141	53,834,535	10,348,468
	Total Liquidity to Asset	48.41%	42.17%	25.74%	4.95%
Contingency Funding Plan	NII	3,772,411	3,602,693	3,314,862	2,948,709
	Non Interest Expense (income)	1,441,000	1,372,224	1,231,745	1,104,256
	Provision of Losses	420,000	413,769	514,173	397,730
	Tax	492,747	468,331	404,462	372,954
	Earnings (I)	1,418,663	1,348,368	1,164,482	1,073,769
	Net Surplus /Deficit (J)	1,416,843	(4,297,002)	(14,593,789)	(42,772,551)
	Wholesale Book (K)	62,747,700	55,427,135	31,373,850	20,915,900
	Wholesale Funding Coverage (L = K / J)	N/A	12.90	2.15	0.49
	Asset-based Funding Sources (M)	37,083,052	37,083,052	37,054,723	32,205,119
	Coverage after LCAP Initialization (L + M / J)	N/A	21.53	4.69	1.24

These ratios highlight the importance of secondary funding sources. Total secondary funding sources is the first liquidity measure that directly relates to all policy limits.

Many banks currently hold high amounts of short-term assets, simply because the inverted yield curve means that assets are providing substantial income. Mean-reversion to a more normal yield curve will lead to lower income being generated by short term assets. In this case, ensuring sufficient liquidity can be costly when cash provides minimal return.

Consider Loan Sales to Augment Liquidity

One solution to increase secondary funding sources for the Contingency Funding Plan is to evaluate your loan book for potential sale candidates. The secondary loan market has become more active in recent years and can be an efficient way to increase liquidity and manage concentration risk if needed. We suggest that CFIs continuously monitor the ability to sell loans by understanding where bids would be at any given time for on-balance sheet loans. It is also recommended that institutions understand the mechanics of loan trading and test this liquidity source periodically. Being connected to a live loan trading platform like Loan Central provides market color to help institutions understand where loans could be executed in a normal or stress situation. We encourage our clients to link their loan book to the platform, so they're prepared to act quickly when needed. Your loans are kept private, but this allows us to provide real-time market color and pricing information. For example, if an inquiry is added to the system that matches loans that you own, we will notify you of the bid, and you can decide if you would like to offer the loans for sale. If not, it still provides a live indication of where you could sell at that time.

Here is a quick checklist to consider in preparing for a loan sale from the banking book:

- Communicate with correspondent banks to understand their requirements and pricing when purchasing loans.
- Utilize our Optimization models to identify loans you would be willing to sell that are executable and wouldn't materially alter the risk profile of your remaining portfolio.
- Ensure loan collateral files are in order and supporting documents match the data tape.
- Prepare the data tape to load into Loan Central and establish a reserve price i.e., minimum bid.

CFIs can conduct a small loan transaction to familiarize themselves with the process as part of the preparation. A well-prepared process can shorten the time to execute a transaction. Furthermore, you can avoid a fire sale of distressed loans, as in the sale of First Republic Bank.

Thomas Ho Company, along with our partners, stand ready to help you with every step of the process from identifying what to sell to evaluating the impact of a sale, and the actual transaction execution.

Selecting a Loan Pool to Prepare for Sale

Identifying loans that are more broadly traded with relatively current market rates are good options to consider for sale if needed. Conforming residential loans are a good choice since they are more generic and there is a larger volume of secondary loan market activity. Nevertheless, other loans such as Non-QM, ITIN loans (as explained in a previous Post), Jumbo loans, FHA and VA loans can also be good options. Mortgage Correspondent loan investors, such as our partner **FutureWave Finance**, are buyers of these types of loans. We encourage our clients to get to know these buyers and their requirements in advance, so they're prepared to act quickly.

Conclusion

Selling loans in the secondary market can be an efficient way to raise liquidity. If you follow the steps outlined above to prepare for a potential loan sale, it may be possible to include selling loans as part of your secondary funding sources for your CFP. This approach can supplement additional wholesale funding options such as FHLB funding, and will thus broaden the diversification of funding sources in your CFP.

Next Steps:

Do not hesitate to reach out to learn more about the Contingency Funding Plan and the use of asset sales as another source of funding.

To learn more or arrange a demo, please contact Megan Trillet, Director of Marketing, at (330) 687-0608 megan.trillet@thomasho.com.

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