Loan PARTICIPATIONS by alloya

LP QUARTERLY

Q2 . 2022

Alloya's Quarterly
Loan Participation Newsletter

IN THIS ISSUE

VOL 4

ALLOYA'S STRATEGIC GOALS

At Alloya, every decision is grounded in our mission to support credit union success and our dedication to three strategic goals: **People, Member Service, and Financial Performance and Compliance.** Alloya's quarterly loan participation newsletter is no exception. We hope you enjoy the latest edition of our quarterly newsletter and subscribe at **www.alloyacorp.org/subscriptions** to receive future issues to your inbox!

GET TO KNOW PARKER HAUSEKNECHT

Coordinator, Capital Markets

We are thrilled to introduce you to the newest member of Alloya's Capital Markets team, Parker Hauseknecht! Based in Saratoga Springs, Utah, Parker has a deep understanding of financial markets through his experience in securities lending and capital market analysis. He holds a bachelor's degree in finance and a Master of Business Administration. In his first month of service at Alloya, Parker increased the awareness and depth of Alloya's Subordinated Debt Program. Parker has a keen eye for the process of issuing debt, and a passion for bringing Alloya's world-renowned service to credit unions through our capital markets initiatives. Parker is excited to support credit union success through Alloya's Subordinated Debt Program and additional capital markets programs.

SUBORDINATED DEBT

A New Alternative to Capital Markets

On January 1, 2022, NCUA enacted a new regulation, allowing more credit unions the opportunity to access the capital markets than ever before. While the majority of ink spilled on subordinated debt is focused on issuing this instrument to increase capital ratios, Alloya believes credit unions are primed to pick up some additional income through investing in other credit unions.

Similar to other products in the credit union world, there are requirements that must first be met before investing in subordinated debt. Understand first that credit unions have been investing in other credit unions' secondary capital since 1996, so the process of investing or lending another credit union's funds is not new. However, with the new regulation in place, the opportunity to invest in credit union subordinated debt will now be more readily available for those credit unions looking to put their excess funds to good use – and at a good return.

In order to invest in debt, the first step is to educate yourself and your board on the risks, returns and process of investing. Involved in this step is getting a board-approved policy in place. The policy can be either in your lending policy or your investment policy, or in a stand-alone policy of its own. The policy should indicate:

01. The aggregate amount you can invest in subordinated debt *(25% of net worth max)*

02. The individual amount in any one originator *(15% of net worth max)*

03. The due diligence that you will perform on the issuing credit union

04. The board review and approval of each respective purchase of a subordinated debt issuance

(continued on page 3)

(continued from page 2)

Mentioned above, investing in subordinated debt may bring an above-average return compared to other investment opportunities in today's market. Currently, we see comparable credit union subordinated debt issuances are garnering a return of 4%-7% for 10-year terms. This is an increase of 1.5% above the risk-free return in a 10-year Treasury bond. One thing to keep in mind is that the subordinated debt market is new to credit unions, and that the yield on the subordinated debt investment will be based on the financial strength of the issuing credit union and its capability to repay the issued debt.

Since this is a relatively new investment type for credit unions (in terms of opportunities available to purchase), the market on yields is relatively unknown. This is a great opportunity for credit unions to work together to meet respective balance sheet needs, with the issuer receiving the funds and the investor receiving an above-market rate compared to other investment opportunities.

THE WINDS, THEY ARE A-CHANGIN'

In what feels like the first time in forever, the loan participation market has started to change. Specifically, the change is related to decreased liquidity for credit unions due to an outflow of deposits and an uptick in loan originations.

What does that mean? That means there is more inventory in the market for credit union buyers than ever before. More credit unions are selling loan participations to meet balance sheet needs, and thus there's more opportunities for credit unions who are flush with liquidity to access the market and get a solid return for their investment.

Below, we note the overall move in spreads, but a quick summation is this:

Increased inventory + decrease in liquidity + rising investment yields = ***better returns for investors***

Over the past three years, due to a lack of inventory and a massive influx of liquidity into the system, investors have seen yields compress, with few alternatives in which to place their money. With the sudden change in the market, the time is now for investors to put their money to use in great available opportunities.

Too often the loan participation marketplace data is obscured by brokers who are looking to extract as much value as possible from credit unions for their own personal gain. At Alloya, we are accountable to credit unions. That's why we deliver transparent market data and insight to help our members make better-informed loan participation purchase and sale decisions.

VOLUME

The Loan Participation Platform saw its largest month by volume in April of 2022. We are seeing a material increase in new sellers on the platform, while at the same time, we are experiencing tremendous unmet demand from investing credit unions. We are bringing on several new buyers per week. If you are a purchasing institution, please make sure you have submitted a pool request. This will allow us to ensure you are made aware of the new inventory that will be sold on the platform.

RATES & SPREADS

As the reader is aware, high volatility presented myriad challenges to lenders in the first quarter. Spreads on loan participations have narrowed versus long-term averages, largely driven by the rapid increase in Treasuries. Net yields on loan participations have increased alongside changes in market rates, albeit at a slower pace. This has resulted in a narrowing of spreads that are now beginning to moderate toward long-term averages. Loan participation transactions tend to lag behind changes in market movements due to the additional time required to complete a loan participation transaction compared to marketable securities.

LOSS & PREPAYS

Prepayment activity has slowed considerably, as one might expect due to the increase in market rates. While refinancing activity is continuing at the margins, the overall rate of prepayment speeds is considerably lower compared with activity seen in 2021. We expect this trend to continue for the near term if market rates continue to increase.

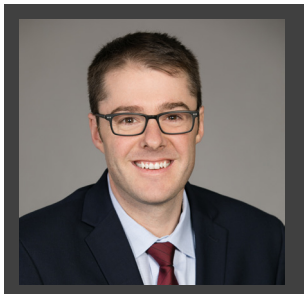
Subscribe to Receive Next Quarter's Issue

We hope you enjoyed the fourth edition of the *LP Quarterly* and will consider reading again when we release another edition in Q3. We encourage you to share the wealth – of knowledge, that is. Consider inviting a colleague to read the *LP Quarterly* and encourage them to subscribe so they receive the next issue straight to their inbox.

Visit **www.alloyacorp.org/subscriptions** to sign up.

THE 1 THING

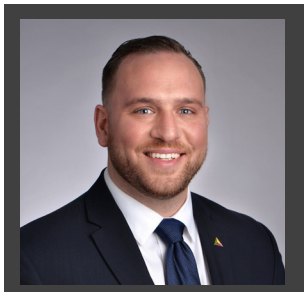
To close out every *LP Quarterly*, the Loan Participation team will share "one thing" they consider to be most important in the current state of the market.



RYAN McCARROLL
VP, LOAN PARTICIPATIONS

RYAN'S ONE THING

Don't try to time the market. In times of rising rates, it is tempting to take a "wait and see" approach. The problem with this philosophy is that we simply cannot predict the market. I spent the years following the '07-'08 financial crisis as an investment advisor to credit unions. Unfortunately, many credit unions kept their duration too short for fear of rising interest rates. While this may seem prudent, the lost income from being underinvested was significant and resulted in considerably lower capital than if they had been fully invested. Often, this underinvestment is driven by the "wait and see" approach to interest rate changes. This seemingly innocuous strategy is merely a disguised exercise in market timing. While it is true that rates may move against you, the opposite is equally true, and there is a real and tangible cost to waiting on the sidelines for the right time to invest.



BILL PATON
VP, LOAN PARTICIPATIONS, LENDING & SUBORDINATED DEBT

BILL'S ONE THING

Efficiency is the name of the game. For credit unions who sell loan participations, if you are running numerous platforms to service your various investors, consider consolidating through Alloya's platform. Our technology and people are there for your benefit. Offload the headaches by leveraging our program to service your already-sold loan participations.

BRIAN MYERS
CONSULTANT, LOAN PARTICIPATIONS

BRIAN'S ONE THING

Pool requests – but the opposite. Since the market has quickly changed, sellers can utilize the pool request function to scan available purchase requests to build pools that fit their balance sheet goals. This allows sellers to build customized pools for buyers, and nearly guarantee a sale since they're building to suit. It's a win/win while utilizing Alloya's platform to their benefit.