FHN FINANCIAL

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WHAT'S WORKING

Index Diversification with SBA Pools

Many, if not most, of the floating rate securities held in depository portfolios are currently indexed to LIBOR. With the planned cessation of LIBOR at the end of 2021, SBA 7(a) pools provide a great option to further diversify your index mix prior to LIBOR's elimination.

While much work has already been done on the transition away from LIBOR, the initiative is starting to get a lot more attention from key stakeholders. Much of the effort now is focused on working out the operational details of the preferred replacement benchmark, the Secured Overnight Financing Rate (SOFR).

With the targeted date of LIBOR's cessation approaching, some institutions with large exposures to LIBOR have already begun to further diversify their index mix. SBA 7(a) pools provide a great vehicle for doing this given the following considerations:

- SBA pools are one of the few instruments tied to Prime Rate.
- Prime is an administrated rate and is not impacted by daily market volatility or market driven phenomena, such as we saw with overnight repo rates last fall.
- Prime has moved lock-step with the Fed Funds Target Rate over the last two decades, maintaining a constant spread of 300 basis points. In effect, a bond that resets at Prime less 250 basis points is equivalent to resetting at 50 basis points over the Fed Funds Target Rate.
- Prime has been well correlated to both 1-month Libor and the 1-year CMT rate, as can be seen in Charts 1 and 2 on the following page.

Beyond index diversification, the flat nature of the yield curve creates very good relative value in SBA floaters, with current yields exceeding those of much longer-term fixed rate alternatives. Pools priced close to par provide current yields of over 2.00%, while those priced at premiums can yield close to 2.50%, depending on specific price point and level of prepay speeds.

It's also noteworthy that that the SBA 7(a) market has grown considerably in recent years. Total annual issuance the last four years has averaged $8.2 billion, compared to an average annual issuance level of only $3 billion in the early 2000s. This increased volume has made for a much more active secondary market with better overall liquidity.

PORTFOLIO STRATEGIES

Gray Bowles
901.435.8170
gray.bowles@fhnfinancial.com

Derick Garner
901.435.4784
derick.garner@fhnfinancial.com

David Howard, CFA
901.435.8217
david.howard@fhnfinancial.com

Curtis Knotts
901.435.8038
curtis.knotts@fhnfinancial.com

Zach Wade, CFA
901.435.8440
zach.wade@fhnfinancial.com

Tyler Williamson
713.435.4349
tyler.williamson@fhnfinancial.com

Price Yates
901.435.4733
price.yates@fhnfinancial.com

Kenneth Young
713.435.4454
kenneth.young@fhnfinancial.com

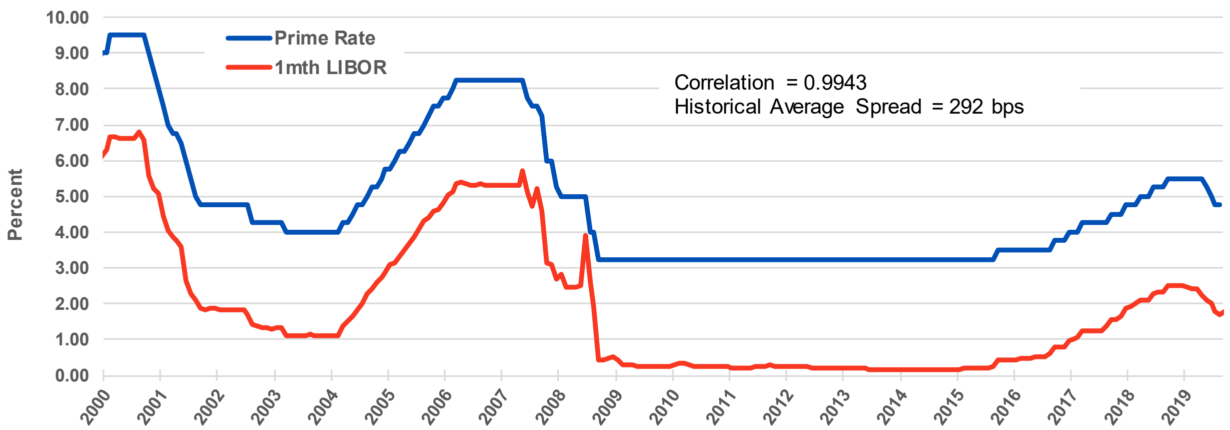
Ruben Rodriguez
713.435.4451
ruben.rodriguez@fhnfinancial.com

Steve Twersky, CPA
901.435.8703
steve.twersky@fhnfinancial.com

FHNFINANCIAL.COM
800.456.5460

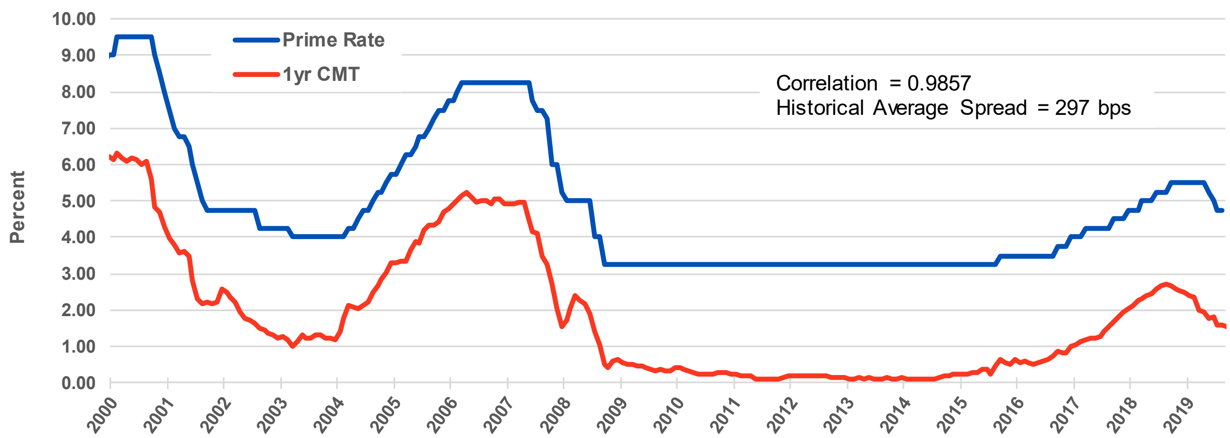
FHN Financial is very active in SBAs, with many dedicated traders and analysts that specialize in this sector. Beyond our active involvement in the secondary market, we have been responsible for pooling over 18% of new 7(a) issuance since 1985.* Let us know if you have any questions about SBA floating rate pools or would like to learn more about these instruments.

Chart One – Prime Rate vs. 1-mo LIBOR



Source: Bloomberg

Chart Two – Prime Rate vs. 1-yr CMT



Source: Bloomberg

– Ruben Rodriguez and Steve Twersky

*On April 3, 2017, FTN Financial (later rebranded as FHN Financial) acquired the assets of Coastal Securities, Inc ("Coastal"). Coastal was a major market maker and pool assembler in the Small Business Administration ("SBA") secondary market. The pooling figure reflects the inclusion of all pools formed by Coastal, FTN Financial and FHN Financial.