



presents

FASB Statement 166 and Commercial Loan Participations

Meeting Complex Accounting and Disclosure Standards for Lead and Participating Lenders

A Live 110-Minute Teleconference/Webinar with Interactive Q&A

Today's panel features:

Bill McGaughey, Executive Vice President and Director of Capital Markets, **Excel National Bank**, Beverly Hills, Calif.
Brett Schwantes, Senior Manager and Technical Issues Committee Chair, **Wipfli LLP**, Wausau, WI
Melissa Beck, Attorney, **Morrison & Foerster**, New York
Ken Kohler, Partner, **Morrison & Foerster**, Los Angeles

Wednesday, March 24, 2010

The conference begins at:

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12 pm Central

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Briefing Document: FASB Statement 166 and 167

The FASB concluded its deliberations of two proposals on May 18, 2009 which were finalized as standards on June 12, 2009. One of the proposals relates to the consolidation of variable interest entities, and one will amend existing guidance for when a company “derecognizes” transfers of financial assets. A variable interest entity (VIE) is a business structure that allows an investor to hold a controlling interest in the entity, without that interest translating into possessing enough voting privileges to result in a majority. After considering all of the feedback received on these original proposals exposed for comment in September 2008, the FASB concluded its deliberations and expects to issue final standards in June 2009.

Both new standards will require a number of new disclosures.

FIN 46(R) amends existing consolidation guidance for variable interest entities. Variable interest entities generally are thinly-capitalized entities and include many “special-purpose entities”, or “SPEs.” The primary amendment to FIN 46(R) relates to how a company determines if it must consolidate a variable interest entity. Under GAAP, a company must consolidate any entity in which it has a “controlling interest.” The new standard now requires a company to perform a qualitative analysis when determining whether it must consolidate a variable interest entity. Under the standard, if the company has an interest in a variable interest entity that provides it with control over the most significant activities of the entity (and the right to receive benefits or the obligation to absorb losses) the company must consolidate the variable interest entity. Under the new standard, the quantitative analysis often used previously is no longer, by itself, determinative. The newly-approved standard requires ongoing reassessments to determine if a company must consolidate a variable interest entity. This differs from existing guidance, which requires a company to determine if it consolidates a variable interest entity only when specific events occur. Under existing guidance, as expected credit losses increased significantly due to unpredicted market events, some companies did not reconsider whether they should consolidate a variable interest entity. The new standard requires a company to update its consolidation analysis on an ongoing basis.

The new standard requires a company to provide additional disclosures about its involvement with variable interest entities and any significant changes in risk exposure due to that involvement. A company will be required to disclose how its involvement with a variable interest entity affects the company’s financial statements. For example, if a company consolidates a variable interest entity and the assets of that consolidated entity are restricted, the company must disclose the nature of those restrictions and the carrying amount of such assets. A company will also be required to disclose any significant judgments and assumptions made in determining whether it must consolidate a variable interest entity.

The second standard now headed for finalization—Statement 140—enhances information reported to users of financial statements by providing greater transparency about transfers of financial assets and a company’s continuing involvement in transferred financial assets. It removes the concept of a qualifying “special-purpose entity” from U.S. GAAP, changes the requirements for derecognizing financial assets, and requires additional disclosures about a transferor’s continuing involvement in transferred financial assets.

A special purpose entity is a legal entity created to fulfill narrow,

specific or temporary objectives. SPEs are typically used by companies to isolate the firm from financial risk. A company will transfer assets to the SPE for management or use the SPE to finance a large project—thereby achieving a narrow set of goals without putting the entire firm at risk.

Qualifying special-purpose entities (QSPEs) generally are off-balance-sheet entities that are exempt from consolidation. The new standard eliminates that exemption from consolidation. Many qualifying special-purpose entities that currently are off balance sheet will become subject to the revised consolidation guidance in the proposal on consolidations of variable interest entities.

The standard on derecognition restricts when a company may transfer a portion of a financial asset and account for the transferred portion as being sold. Existing guidance permits companies to report many transfers of portions or components of financial assets as sales. Under the new standard, a transfer of a portion of a financial asset may be reported as a sale only when that transferred portion is a pro-rata portion of an entire financial asset, no portion is subordinate to another, and other restrictive criteria are met.

This clarifies the legal isolation requirements to ensure that a company considers all of its involvements and the involvements of its consolidated entities to determine whether a transfer of financial assets may be accounted for as a sale. The newly approved standard also eliminates an exception that currently permits a company to derecognize certain transferred mortgage loans when the company has not surrendered control over those loans.

The new standard requires a company to provide additional disclosures about all of its continuing involvements with transferred financial assets. Continuing involvement can take many forms—for example, recourse or guarantee arrangements, servicing arrangements, and providing certain derivative instruments. The new standard also requires a company to provide expanded disclosures about its continuing involvement until it has no continuing involvement in the transferred financial assets. A company will also need to provide additional information about transaction gains and losses resulting from transfers of financial assets during a reporting period.

Generally, the approved standards will be effective as of the beginning of 2010 and will apply to existing entities, including existing qualifying special purpose entities. However, the amendments on how to account for transfers of financial assets will apply prospectively to transfers occurring on or after the effective date.


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[Home](#) > [In The News](#) > [In Focus](#) > [2009 Archive](#) > September 2009 e-InFocus

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Feature Article

 by Bill McGaughey
 Excel National Bank


FAS 166 Amends Accounting Rules for Sold 7(a) Loans May Change How YOU Sell Loans

Due to recent changes in Financial Accounting Standard (FAS) 140, SBA lenders involved in the secondary market may not receive sales treatment when selling the guaranteed portion of 7(a) loans at par and retaining more than 1% in lender's fees. In addition, lenders might not be able to record the sale of the guaranteed portion until the warranty period expires.

Changes in the accounting treatment of sales of the guaranteed portion of SBA 7(a) loans could very well impact how you sell loans. In June 2009, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards No. 166, *Accounting for Transfers of Financial Assets* ("FAS 166"). The new FAS 166 standard amends paragraph 8 of FAS 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, through the addition of items 8A and 8B. In order to obtain sales treatment for the sale of a portion of a loan, it must meet the participation definition.

FAS 140 paragraph 8B states that a *participating interest* has the following characteristics:

1. It represents a proportionate (pro rata) ownership interest in an entire individual financial asset.
2. From the date of the transfer, all cash flows received from the entire financial asset are divided proportionately among the participating interest holders in an amount equal to their share of ownership.
3. The rights of each participating interest holder have the same priority, and that priority does not change in the event of bankruptcy or other receivership of the transferor, the original debtor, or any participating interest holder. Participating interest holders have no recourse, other than standard representations and warranties, to the transferor or to each other, and no participating interest holder is subordinated to another.
4. No party has the right to pledge or exchange the entire financial asset.

If the transfer of a portion of a loan meets the definition of a participating interest and the other conditions for sales accounting discussed in FAS 140 paragraph 9, the transfer is treated as a sale. If the transfer does not meet the definition of a participating interest, or does not meet the conditions of FAS 140 paragraph 9, *the transaction is treated as a secured borrowing with pledge of collateral.*

Fortunately, FASB states in FAS 140 paragraph 26H, "Recourse in the form of an independent third-party guarantee shall be excluded from the evaluation of whether the participating interest definition is met. Similarly, cash flows allocated to a third-party guarantor for the guarantee fee shall be excluded from the determination of whether the cash flows are divided proportionately among the participating interest holders." Therefore, it appears that lender's who sell the guaranteed portions of SBA 7a loans, will still be able to get sales treatment, if the loan is sold for a premium.

The timing of recording the loan sale might be impacted by FAS 140 paragraph 26G: "In certain transfers, recourse is provided to the transferee that requires the transferor to reimburse any premium paid by the transferee if the underlying financial asset is prepaid within a defined time frame of the transfer date. Such recourse would preclude the transferred portion from meeting the definition of a participating interest. However, once the recourse provision expires, the transferred portion shall be reevaluated to determine if it meets the participating interest definition." *This means that the 90 day warranty period for prepayments might result in the loan sale being recorded 90 days after settlement.*

It appears that SBA par sales or sales where the originating lender retains an excessive permanent lender's fee would result in the transaction not meeting the participating interest definition. FAS 140 paragraph 26F states, "For example, if the transferor transfers an interest in an entire financial asset and the transferee agrees to incorporate the excess interest into the contractually specified servicing fee, the excess interest would likely result in the conveyance of an interest-only strip to the transferor from the transferee. *An interest-only strip would result in a disproportionate division of cash flows of the financial asset among the participating interest holders and would preclude the portion from meeting the definition of a participating interest.*"

FAS 166 shall be effective as of the beginning of each reporting entity's first annual reporting period that begins after November 15, 2009, for interim periods within that first annual reporting period and for interim and annual reporting periods thereafter. Earlier application is prohibited. The recognition and measurement provisions of FAS 166 shall be applied to transfers that occur on or after the effective date. Thus it appears that the transactions recorded under the previous guidelines will not have to be restated.

SBA lenders that sell their loans are encouraged to discuss FAS 166 with their independent accountants to plan for the changes coming in 2010.

[Review FAS 166 >](#)



Don't miss Bill McGaughey (Excel National Bank) & Stuart Mitchell (BBVACompass) as they present the annual conference breakout session *Discover the Impact of the New Accounting Rule for Sold Loans.*

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Bob Judge, Government Loan Solutions, Editor



Bob Judge is a partner at Government Loan Solutions.

Government Loan Solutions is a provider of valuation services, prepayment analytics and operational support for the SBA marketplace.

Bob has 25 years of experience in the fixed income markets. He holds a B.A. in Economics from Vassar College and an M.B.A. in Finance from NYU Stern School of Business.

INSIDE THIS ISSUE:

Special points of interest:

- Prepayments Fall
- FASB 166 and SBA Lending
- December TALF Update
- Default Rate falls

November CPR	1-2, 14-16
FASB 166	1 & 4
Default Curtailment Ratios	10 & 19
December TALF	5
Sale & Settle Tip	7
GovGex Corner	8
Value Indices	9, 11-13
Default Rate	10

NOVEMBER CPR: PREPAYMENTS FALL BELOW 8%

After a jump in October, prepayment speeds fell 23%, dropping to CPR 7.34% last month. October notwithstanding, prepayment speeds have returned to the sub-8% prepayment trend that began in July of this year. In fact, preliminary data from Colson for December suggests that next month's prepayment speed could be sub-7%

and possibly below the record low of CPR 6.55% set in September..

To date, the 2009 overall prepayment speed is CPR 8.85%, having fallen from a YTD in October of 9.00%.

The **Voluntary Prepay CPR (green line)** remained below 3% for the sixth month in a row and remained at VCPR 2.73%. With the VCPR

remaining the same, the **Default CPR (red line)** was the reason for the decrease in overall prepayments.

Specifically, the DCPR fell 32% to 4.61% from 6.79% in October. This reading was the second time the DCPR has fallen below 5% this year, with

Continued on page 2

FASB 166 AND SBA LENDING

By Bill McGaughey

Implementation of Financial Accounting Standard ("FAS") 166 for most lenders is January 1, 2010. The sale of the guaranteed portion of SBA 7a loans will change with the implementation of FAS 166. If the lender retains more than the 1% minimum lenders permanent fee, the transaction will be treated as a secured borrowing and not a sale. If the lender sells the guaranteed portion for a pre-

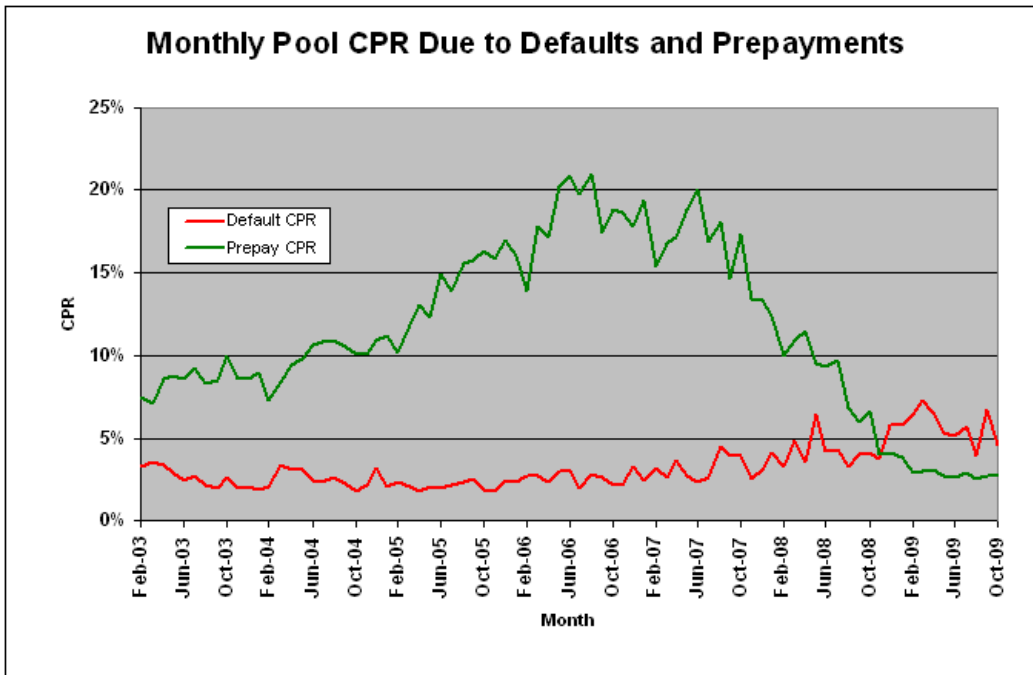
mium and only retains 1%, the transaction will be treated as a secured borrowing until the 90 day warrant period for prepayments expires and/or the borrower's first three payments are received in the month in which it was due. After the warranty period expires the transaction can be treated as a sale.

The implementation will have negative impacts to lenders that sell their guaranteed portions of

SBA 7a loans. The first impact is the loss of income from the gain on sale of loans that have been sold with a lenders permanent fee in excess of 1%. The second impact is the delay in recognizing the gain on sale of loans that were sold for a premium with the retention of a 1% lenders permanent fee. The third is the impact of not being able to remove the guaranteed portions of SBA 7a loans from

Continued on page 4

NOVEMBER CPR...CONTINUED



“With the Default CPR falling back below 5% and next month’s reading expected to be below 4%, fears of defaults reaching double-digits this year have fortunately not materialized.”

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the low of 3.96% having been seen in August.

For November, prepayment speeds fell in five out of the six maturity categories. The largest decrease was seen in the 16-20 year maturity bucket, which fell 57% to CPR 5.69%. Other decreases were seen in the 20+ (-39% to CPR 4.95%), 13-16 (-11% to CPR 6.68%), 8-10 (-6% to CPR 12.05%), and <8 (-3% to CPR 9.72%). The only increase was seen in the 10-13 category, which rose by 3.24% to CPR 11.72%.

With the Default CPR falling back below 5% and next month’s reading expected to be

below 4%, fears of defaults reaching double-digits this year have fortunately not materialized.

From a prepayment perspective, this is good news. The recent recipe of voluntary prepayments below 3% and defaults sub-6% calls for an expectation of sub-10% for over all prepayment speeds into 2010.

As to how long we can remain in a sub-10% prepay environment, our expectation is for single digit speeds throughout next year.

The reason for this call is that defaults continue to trend down and there is no reason to believe that voluntary prepayments will approach pre-2008 levels.

From an investor perspective SBA-related assets remain attractive, from a fundamental point of view, as we head into the new year.

For further information on the terminology and concepts used in this article, please refer to the “Glossary and Definitions” at the end of the report.

Data on pages 14-16

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SBA 7(a) Lender's Gain on Sale
Income to be Reduced by 25% in 2010.
FAS 166 will delay secondary market
sale gains by 90 days beginning Jan 1st.

What is your Strategy? How will you Cope?

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Speakers

Bob Judge, Partner, Government Loan Solutions, Cleveland, OH

In October 2006, Bob, along with Scott Evans and Rob Herrick, founded Government Loan Solutions, Inc. (GLS), for the purpose of bringing greater efficiencies and productivity to the SBA marketplace, through the use of technology.

Bill McGaughey, Executive Vice President, Excel National Bank, Beverly Hills, CA

Bill McGaughey is the Executive Vice President and Director of Capital Markets at Excel National Bank. Bill is the author of Accounting for SBA Loans Sold in the Secondary Market, published by NAGGL in 2008.

FASB 166...CONTINUED

the lender's balance sheet, which results in the lender having to provide capital for guaranteed portions of SBA 7a loans sold.

If a lender were originating and selling \$5,000,000 in guaranteed portions a month, the delay in sales treatment per FAS 166, would result in the lender having to retain an additional \$750,000 in capital based on a leverage ratio of 5%. (\$5,000,000 x 3 months x 5%) Also, due to the delay the lender would postpone the recognition of approximately \$1.2 million in income during the first year of adoption of FAS 166. (The income is based on \$15,000,000 in loan sales at 110% with an assumption that 80% of the premium would be recognized as income.)

Example: A SBA 7a loan is made for \$1,000,000 for 25 years with an interest rate of prime + 2.75% (6%). The guaranteed portion of \$900,000 is sold on the same day for 108% or \$972,000 with a pass through rate of prime + 1.75% (5%). The implicit interest rate of the sold portion of the note is 3.85%. (The implicit interest rate is based on \$972,000 with payments of \$5,049 a month over 300 periods.) The accounting entries would be as follows:

Make the Loan:

Loans	\$1,000,000
Cash	\$1,000,000

Settle the loan sale:

Cash	\$972,000
Secured Borrowing	\$972,000

Balance Sheet:

Assets:

Cash	\$972,000
Loans	<u>\$1,000,000</u>
Total Assets	<u>\$1,972,000</u>

Liabilities:

Secured borrowing	\$972,000
Equity	<u>\$1,000,000</u>
Total Liabilities and Equity	<u>\$1,972,000</u>

1st Payment received:

Cash	\$6,443
Interest Income	\$5,000
Loans	\$1,443

1st Payment sent to guaranteed holder:

Secured Borrowing	\$1,930
Interest Expense	\$3,119
Cash	\$5,049

After the first 3 payments are received and 90 days, recognize the loan sale¹:

Servicing Asset	\$14,785
Secured Borrowing	\$966,189
Loans	\$896,085
Discount on Unguaranteed	\$7,866
Gain on Sale	\$77,023

As shown above, FAS 166 will add a new level of complexity to accounting for SBA 7a loan sales and could have a significant negative impact to a lender's capital ratios and income in 2010.

Footnote:

¹Information on the numbers: Value of servicing asset (995,650 x (1% - .4%) x 2.75); Cost allocation Guaranteed fair value 980,974 (secured borrowing balance 966,189 + 14,785 servicing asset) or 90.79% of the total fair value; Unguaranteed fair value (gross loan balance \$995,650 x 10%) 99,565 or 9.21% of the total fair value; Discount on unguaranteed (995,650 x 10%) - (996,650 x 9.21%) = 7,866; Gain = (servicing asset 14,785 + secured borrowing 966,189) - (Note balance 995,650 x 90.79%)

About the Author:

Mr. McGaughy is the Executive Vice President and Director of Capital Markets at Excel National Bank. Bill is the author of *Accounting for SBA Loans Sold in the Secondary Market*, published by NAGGL in 2008. He has experience originating, purchasing, selling and securitizing SBA 7(a) and 504 loans. He is on NAGGL's Secondary Market Committee and is a former member of NAGGL's board of directors. He has a B.S. in accounting from the University of Northern Colorado, holds a State of Colorado CPA certificate, holds the designation of CFA, and is a graduate of Pacific Coast Banking School.

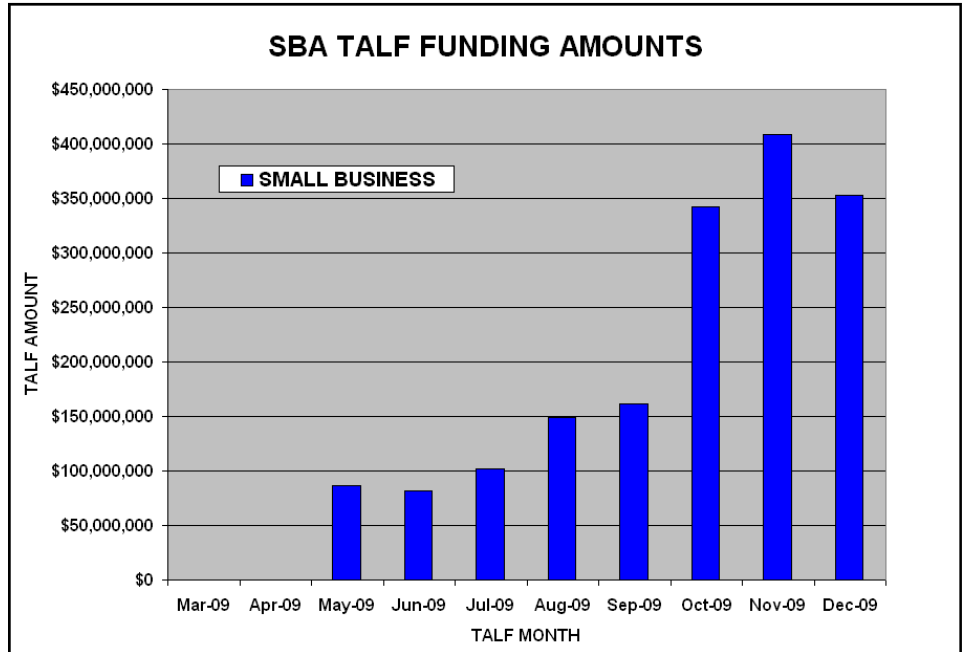
DECEMBER TALF UPDATE

After five months of volume increases, small business ABS financed by the TALF decreased by \$55 million, or 14%, in December.

While the last few months have been dominated by 7a pool financings, we estimate that slightly less than 50% of the securities funded this month were 7a pools, with the rest being 504 debentures.

Because of their fixed-rate nature, 504 debentures are considered "riskier" assets inside the TALF, due to the uncertainty regarding future interest rates and the value of the security at the end of the TALF period. For this reason, floating-rate 7a pools possess less interest rate risk and are, generally speaking, more attractive to the average TALF investor.

With 7a pool assemblers having securitized their inventory of high gross margin, long maturity loans faster than they can replace them, we suspect the decrease was due to a lack of supply, as opposed to slackening demand for high margin, long dated pools. SBA 7a pools continue to be popular with TALF investors, due to the return advantages over other TALF asset classes. Utilizing our assumptions for prepayment speeds and exit prices, TALF returns on 7a pools continue to be in the 8% to 10% range, as compared to sub-5% on many other TALF investment options.



With the TALF scheduled to end in March of next year, we are nearing the end of the "TALF impact" on the 7a secondary market.

Due to the fact that the last pool origination month that can go into the TALF is February, loans purchased in December, January and early February will be the last ones placed into TALF-eligible pools, barring an extension of the program.

Can the secondary market maintain the price increases seen in the past few months without TALF?

We will likely find out the answer to that question sometime in the first quarter of 2010.



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In these times of market uncertainty, let GLS help you in determining the value of your SBA and USDA related-assets.

For further information, please contact Rob Herrick at (216) 456-2480 ext. 144 or at rob.herrick@glsolutions.us

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GLS 7(a) Sale & Settlement Tip of the Month

Sale and Settlement Strategies: Tip #16 – Don't count on miracles...

At least not when it comes to last minute settlements. While this has been mentioned more than once in this piece recently, it bears repeating – DO NOT WAIT until the last minute and expect Colson to push loans through the settlement process. If you have sold loans pending corrections, it is imperative to take immediate action to rectify the problem and communicate this to Colson and your buyers. With 166 taking effect in January, this is more important this year than any year before. Loans settling in 2010 will be subject to the new accounting rules, no ifs, ands, or buts.

*Scott Evans is a partner at GLS. Mr. Evans has over 18 years of trading experience and has been involved in the SBA secondary markets for the last eight of those years. Mr. Evans has bought, sold, settled, and securitized nearly 20,000 SBA loans and now brings some of that expertise to the CPR Report in a recurring article called **Sale and Settlement Tip of the Month**. The article will focus on pragmatic tips aimed at helping lenders develop a more consistent sale and settlement process and ultimately deliver them the best execution possible.*



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THE GOVGEX CORNER

The **GovGex Index™** reached a record high in the 25-year loan category during the month of November, while 10-year loans edged down slightly but remained close to October prices. Fully priced 25-year loans continued to trade at 110, with servicing becoming the playing field for bidders, reaching up to 1.3%. To account for the increased servicing fees, we updated our pricing model for November, resulting in more accurate predictions for the loans that fetch the highest premiums.

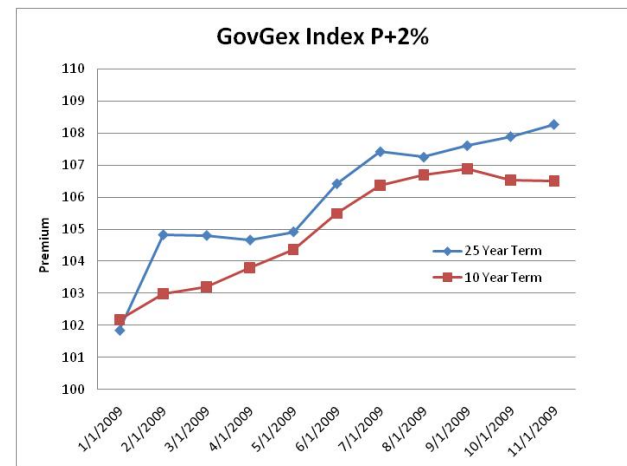
Below is recent price and trend information on SBA loan sale premiums as reported by the GovGex Independent Pricing Service. **GovGex Transactions** shows actual bids received on loans presented for sale through **GovGex**. The **GovGex Index™** shows what a Prime + 2 loan of the given term that had just been funded would sell for in each month. The GovGex Index robustly captures month-to-month pricing trends, while also controlling for factors including the age of the loan at the time of sale. For 10 year loans, the Index premium fell 10 basis points between October and November, and for 25 year loans, the premium rose a striking 40 basis points, crossing 108 for the first time.

GovGex Transactions—Nov

Deal Term	Premium	Servicing
25	110.00%	1.30%
15	110.00%	1.23%
10	109.50%	1.00%

GovGex Index™ P + 2%

Month	10 Year	25 Year
Sep	106.9	107.6
Oct	106.6	107.9
Nov	106.5	108.3



Note: the above tables represent aggregated data. Subscribers of the **GovGex Independent Pricing Service™** receive regular updates of actual transactions and bid levels on **GovGex** - including loan details and high premium and par bids. Recent reports show P+2.75 transactions at **107% to 110%** range, with only slight changes in loan structure driving premiums. Lenders use the pricing service to structure deals in light of what the market is currently valuing. The **GovGex Independent Pricing Service** is the only service to provide *actual bid levels* based on loans presented for sale on **GovGex**.

About GovGex.com

GovGex is the secure online exchange for selling SBA and USDA loans. GovGex works with a network of over 30 Buyers, including the leading pool assemblers who are so critical to providing liquidity to small business lenders – a vital engine for American growth. GovGex is an independent source for secondary market pricing information - built on actual bid levels as seen on GovGex. Contact GovGex for all of your secondary market needs.



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STABILITY SEEN IN THE GLS VALUE INDICES

The GLS Value Indices remained mostly stable in October, as the short-end displayed single-digit percentage gains and the long-end single-digit percentage decreases. This result was not unexpected, as the sub-15 year maturities decreased in price in October while the long-end witnessed continued servicing bid increases.

While the movements were not as large as in past months, the prepayment element continues to decrease and the Base Rate / Libor spread continues to increase.

Specifically, the Base Rate / Libor spread rose for the eighth month in a row, reaching 299 basis points, a 3 basis point increase over September. We are now within 10 basis points of the all-time high of 309 bps seen in January, 2008. Additionally, the prepayment element decreased

in four out of six maturity sectors.

As we have seen in past few months, increasingly positive fundamentals were important in maintaining the indices, especially in the long-end where the secondary market continued to rally throughout October.

Turning to the specifics, the largest increase was in the GLS VI-4, which increased by 5.13% to 216 basis points. Other single-digit increases were recorded in VI-1 (+5.10% to 128.2), VI-3 (+4.36% to 133.9) and VI-2 (+3.79% to 131.3).

Decreases were seen in VI-5, which fell by 15.14% to 191.2 and VI-6, which decreased by 0.35% to 228.6.

Since the scheduled end of the TALF for SBA pools is in sight, it will be interesting to see the price action as we approach the

end of the first quarter of 2010.

We expect continued positive fundamentals (i.e. Base/Libor spread and prepayment speeds), but will that be enough to sustain the market?

For further information on the GLS Value Indices, please refer to the "Glossary and Definitions" at the end of the report.

Data on pages 11-12, Graph on page 13

7(a) Secondary Market Pricing Grid: October 2009*

Maturity	Gross Margin	Fees	Servicing	10/30/2009 Price	Last Month Price	3-Mos. Ago Price	6-Mos. Ago Price	Net Margin
10 yrs.	2.75%	0.6750%	1.00%	109.40	109.65	109.25	NA	1.075%
15 yrs.	2.75%	0.6750%	1.00%	109.50	109.80	109.375	NA	1.075%
20 yrs.	2.75%	0.6750%	1.09%	110.00	110.00 / 1.00%	109.50	NA	0.985%
25 yrs.	2.75%	0.6750%	1.14%	110.00	110.00 / 1.07%	109.75	NA	0.935%

**Please note that we have changed the loan descriptions to better reflect the characteristics of loans being sold into the secondary market.*

Content Contributors

The editors of the "CPR Report" would like to thank the following secondary market participants for contributing to this month's report:



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DEFAULT RATE FALLS TO 4.81%

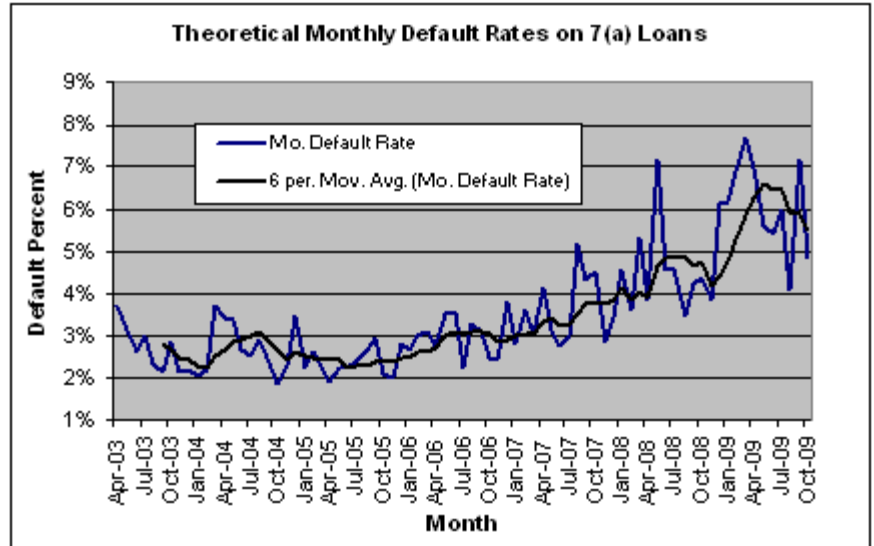
In October, the theoretical default rate fell by 33% to 4.81% from 7.16% in September. This result moves the default rate back in line with the range of 4% to 6% we have seen since the summer months.

This recent range is a positive move from the 6% to 7% range from the first half of 2009.

Even though we have seen some volatility in the last three months, the average default rate in that period was 5.36%, well within recent expectation.

This return to the trend is very positive for 7a lending in particular and small business, in general. While there has been some question regarding the source and quality of economic growth seen in the

third quarter, it would seem that small business is reacting in a positive manner. While we are a



long way from the 2% to 3% default range of earlier this decade, at least we seem to be moving in the right direction.

DEFAULT-CURTAILMENT RATIOS

Because of another record high Default-Curtailment Ratio (DCR) reading, the 504 DCR exceeded the 7a ratio for the third time in four months.

Please note that an increase in the DCR does not necessarily mean that the default rate is rising, only that the percentage of early curtailments attributable to defaults has increased.

As has been the case for nearly the past year and a half, both ratios continued the trend of recession-level readings of 30%+ for 7(a) and 20%+ for 504 loans.

SBA 7(a) Default Ratios

For the 18th month in a row, the 7(a) DCR exceeded 30%, coming in at 62.82%, which represents a 12% decrease from the previous month's record reading of 71.35%. As has been the case all year, this is both a function of low voluntary prepayments and higher defaults.

Turning to defaults, we witnessed a \$42.3 million decrease in October, falling to \$122 million. Voluntary prepayments rose slightly, moving to \$72.1 million from \$65.9 million.

SBA 504 Default Ratios

Also for the 18th month in a row, the 504

DCR came in above 20%, having reached another all-time high of 70.23%, the first reading above 70%. This figure is once again significantly above our threshold for weakened conditions in the 504 small business sector.

Specifically, the dollar amount of defaults increased by \$9.8 million to \$111.8 million in the month of October. At the same time, voluntary prepayments also rose, increasing by \$3.1 million to \$47.4 million, but not enough to lower the 504 DCR.

Summary

In summary, both DCRs continue to suggest weakness in the small business sector.

While we are seeing some positive data regarding defaults, there is still work to be done before we can declare the recession to be over.

For further information on the terminology and concepts used in this article, please refer to the "Glossary and Definitions" at the end of the report.

Graph on page 19

Premiums got you down?

The online auction site for Government Guaranteed Loans

Free Membership

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- ★ Simplified settlement
- ★ Compliance and audit trail
- ★ Keep 100% of proceeds

GLS VALUE INDICES: SUPPORTING DATA

Table 1:

MONTH	BUCKET 1 CPR	BUCKET 2 CPR	BUCKET 3 CPR	BUCKET 4 CPR	BUCKET 5 CPR	BUCKET 6 CPR
May-06	18.84%	17.05%	13.80%	14.99%	19.00%	20.39%
Jun-06	19.80%	18.23%	13.34%	15.88%	19.57%	21.59%
Jul-06	20.48%	19.32%	13.77%	16.88%	19.58%	22.41%
Aug-06	19.27%	19.32%	14.15%	17.76%	20.10%	23.06%
Sep-06	20.33%	19.89%	14.29%	18.83%	20.84%	24.55%
Oct-06	19.72%	19.72%	14.32%	19.17%	20.42%	24.51%
Nov-06	18.17%	19.54%	14.82%	19.32%	20.91%	24.83%
Dec-06	16.78%	18.62%	14.44%	18.97%	20.67%	24.48%
Jan-07	16.44%	17.36%	13.95%	18.23%	20.89%	24.14%
Feb-07	17.47%	17.00%	13.86%	17.95%	21.81%	24.21%
Mar-07	16.07%	16.65%	13.54%	17.22%	20.95%	23.23%
Apr-07	16.21%	16.49%	13.55%	17.99%	19.52%	23.13%
May-07	18.09%	17.35%	13.47%	18.38%	19.68%	22.95%
Jun-07	18.39%	17.03%	13.89%	18.96%	20.60%	22.97%
Jul-07	18.52%	17.35%	14.00%	19.55%	20.25%	23.25%
Aug-07	17.72%	17.15%	13.56%	19.48%	18.01%	23.10%
Sep-07	19.18%	17.10%	14.19%	19.85%	18.61%	23.98%
Oct-07	18.14%	17.04%	14.59%	19.16%	18.57%	23.85%
Nov-07	17.68%	16.02%	14.82%	18.87%	18.32%	24.16%
Dec-07	17.14%	15.38%	14.42%	17.22%	17.99%	23.23%
Jan-08	15.70%	14.68%	13.96%	16.44%	17.45%	22.00%
Feb-08	15.91%	13.98%	14.19%	16.20%	17.53%	21.19%
Mar-08	15.58%	13.42%	13.27%	15.08%	15.41%	19.34%
Apr-08	16.16%	13.40%	13.05%	14.59%	15.19%	18.74%
May-08	15.49%	12.93%	12.65%	13.77%	14.33%	17.33%
Jun-08	15.29%	13.36%	12.96%	14.75%	13.62%	17.14%
Jul-08	15.70%	13.03%	12.78%	14.40%	12.49%	16.59%
Aug-08	15.45%	13.28%	12.87%	13.73%	12.24%	15.89%
Sep-08	14.03%	12.49%	12.77%	13.28%	12.36%	15.20%
Oct-08	12.98%	11.67%	12.16%	12.13%	11.97%	14.06%
Nov-08	12.08%	12.36%	11.45%	11.49%	11.49%	13.22%
Dec-08	12.37%	11.81%	10.46%	9.79%	11.08%	11.41%
Jan-09	12.86%	11.55%	10.45%	9.29%	10.61%	10.40%
Feb-09	12.30%	11.30%	10.36%	8.39%	9.99%	9.30%
Mar-09	12.96%	11.97%	10.58%	8.57%	10.47%	8.79%
Apr-09	13.23%	12.34%	11.23%	8.75%	9.81%	8.55%
May-09	13.12%	11.89%	11.80%	8.68%	9.92%	7.98%
Jun-09	13.18%	11.85%	12.36%	8.57%	8.73%	8.02%
Jul-09	12.40%	12.00%	12.51%	8.56%	8.23%	7.36%
Aug-09	13.38%	12.49%	12.36%	8.01%	7.34%	7.21%
Sep-09	12.79%	11.01%	11.83%	7.48%	6.70%	6.89%
Oct-09	12.50%	11.03%	11.35%	7.25%	7.85%	6.79%

Rolling six-month CPR speeds for all maturity buckets. Source: Colson Services

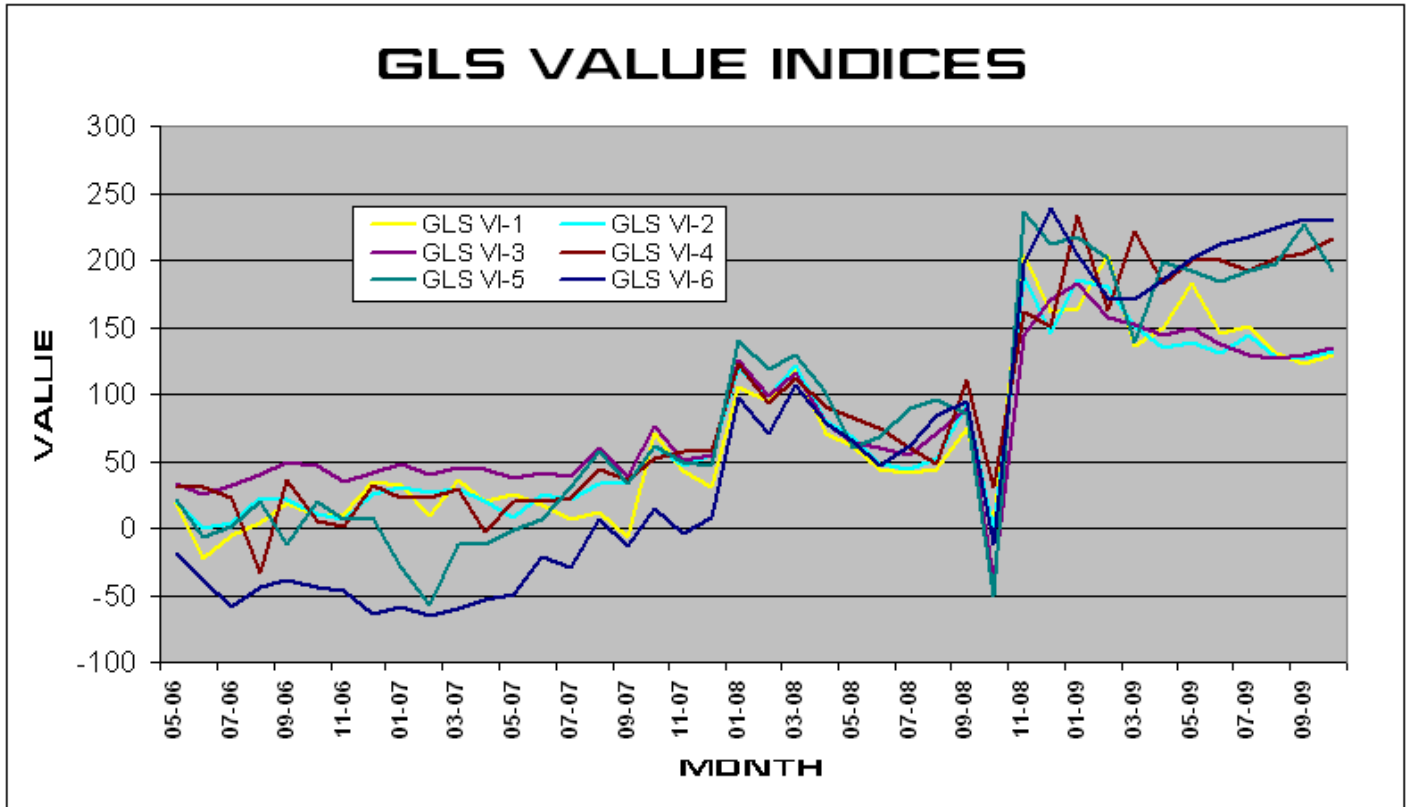
GLS VALUE INDICES: HISTORICAL VALUES

Table 2:

MONTH	WAVG LIBOR	WAVG BASE	BASE LIBOR SPD	GLS VI-1	GLS VI-2	GLS VI-3	GLS VI-4	GLS VI-5	GLS VI-6
May-06	5.18%	7.94%	2.76%	18.4	18.8	33.5	30.2	21.0	-19.5
Jun-06	5.37%	8.03%	2.66%	-22.8	-0.1	25.0	29.6	-6.4	-37.9
Jul-06	5.48%	8.25%	2.77%	-5.9	3.6	31.2	22.0	0.9	-59.1
Aug-06	5.40%	8.25%	2.85%	3.8	21.4	39.8	-33.9	19.7	-43.5
Sep-06	5.37%	8.25%	2.88%	17.8	21.0	49.8	36.2	-12.4	-38.1
Oct-06	5.37%	8.25%	2.88%	10.0	11.3	46.3	5.4	19.1	-43.5
Nov-06	5.37%	8.25%	2.88%	10.9	7.0	33.7	1.4	6.2	-46.7
Dec-06	5.36%	8.25%	2.89%	34.6	24.0	41.1	31.0	8.0	-63.8
Jan-07	5.35%	8.25%	2.90%	31.0	29.8	48.6	21.3	-30.1	-59.4
Feb-07	5.36%	8.25%	2.89%	9.2	25.4	39.4	21.3	-57.0	-65.7
Mar-07	5.34%	8.25%	2.91%	35.9	28.9	45.0	28.5	-12.7	-60.9
Apr-07	5.35%	8.25%	2.90%	18.8	19.4	43.4	-2.9	-12.5	-53.0
May-07	5.35%	8.25%	2.90%	24.5	8.5	37.6	18.9	-1.4	-50.0
Jun-07	5.36%	8.25%	2.89%	16.3	25.2	40.6	18.6	7.0	-22.1
Jul-07	5.35%	8.25%	2.90%	6.8	20.9	38.1	22.2	30.1	-29.9
Aug-07	5.48%	8.25%	2.77%	12.9	33.5	59.8	43.6	57.8	7.0
Sep-07	5.70%	8.21%	2.51%	-7.3	32.2	38.1	36.3	33.3	-14.1
Oct-07	5.05%	7.74%	2.69%	70.2	61.9	75.6	52.2	61.9	14.6
Nov-07	4.96%	7.50%	2.54%	42.6	46.7	50.5	57.8	48.7	-4.3
Dec-07	5.02%	7.35%	2.33%	30.4	55.2	54.4	57.0	46.7	7.9
Jan-08	3.77%	6.86%	3.09%	105.1	118.6	124.7	121.4	140.1	96.8
Feb-08	3.10%	6.00%	2.90%	94.4	98.7	98.6	93.3	118.0	69.9
Mar-08	2.90%	5.95%	3.05%	118.1	120.5	116.2	112.0	128.8	107.4
Apr-08	2.81%	5.25%	2.44%	69.9	79.5	77.4	90.6	100.8	77.4
May-08	2.78%	5.15%	2.37%	61.2	66.7	64.1	82.9	60.5	65.1
Jun-08	2.67%	5.00%	2.33%	44.1	47.4	59.8	74.6	66.9	47.2
Jul-08	2.75%	5.00%	2.25%	41.7	43.4	55.3	60.8	89.1	61.6
Aug-08	2.74%	5.02%	2.27%	44.0	52.5	70.1	47.4	95.8	83.1
Sep-08	3.00%	5.00%	2.00%	73.3	91.2	88.5	111.3	85.2	94.2
Oct-08	4.43%	4.56%	0.12%	2.3	-3.1	-38.6	30.5	-51.0	-12.9
Nov-08	2.06%	4.00%	1.94%	203.9	187.0	143.2	161.1	236.0	196.6
Dec-08	1.64%	3.89%	2.25%	162.2	144.9	170.3	151.0	212.5	238.6
Jan-09	1.11%	3.25%	2.14%	164.8	185.5	181.7	233.2	218.3	204.4
Feb-09	1.15%	3.25%	2.10%	203.6	179.5	157.4	162.9	201.5	171.3
Mar-09	1.06%	3.25%	2.19%	135.3	150.3	151.6	220.4	138.0	169.7
Apr-09	0.96%	3.28%	2.32%	149.4	134.8	144.3	182.0	198.3	184.5
May-09	0.70%	3.26%	2.57%	182.1	138.7	149.6	200.3	192.4	200.8
Jun-09	0.55%	3.25%	2.70%	144.8	130.3	137.3	200.2	183.8	212.8
Jul-09	0.48%	3.25%	2.77%	150.9	143.8	129.1	191.9	192.4	217.4
Aug-09	0.39%	3.25%	2.86%	129.7	127.4	125.7	201.7	197.3	222.8
Sep-09	0.29%	3.25%	2.96%	122.0	126.5	128.3	205.5	225.3	229.6
Oct-09	0.26%	3.25%	2.99%	128.2	131.3	133.9	216.0	191.2	228.8

INDICES LEGEND	
	HIGHEST READING
	LOWEST READING

GLS VI values for all maturity buckets for last 42 months.



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YTD PREPAYMENT SPEEDS

Table 3:

CPR/MO.	<8	8 - 10	10 - 13	13 - 16	16 - 20	20+	ALL
Jan-09	16.67%	9.11%	10.27%	10.30%	8.75%	9.67%	9.94%
Feb-09	10.84%	11.48%	13.12%	7.36%	8.85%	8.09%	9.67%
Mar-09	14.52%	14.16%	11.41%	9.86%	12.85%	7.42%	9.52%
Apr-09	11.84%	12.82%	14.16%	8.76%	6.40%	8.74%	10.30%
May-09	11.75%	13.00%	13.47%	8.35%	9.99%	7.74%	9.79%
Jun-09	13.31%	10.45%	11.73%	6.60%	5.30%	6.42%	8.10%
Jul-09	12.14%	10.19%	11.09%	10.45%	5.69%	5.70%	7.82%
Aug-09	16.59%	14.28%	12.28%	3.77%	3.47%	7.18%	8.68%
Sep-09	11.00%	5.31%	8.01%	6.72%	9.22%	5.52%	6.55%
Oct-09	10.06%	12.81%	11.35%	7.47%	13.09%	8.10%	9.52%
Nov-09	9.72%	12.05%	11.72%	6.68%	5.69%	4.95%	7.34%
Grand Total	12.61%	11.43%	11.71%	7.91%	8.17%	7.23%	8.85%

2009 monthly prepayment speeds broken out by maturity sector. Source: Colson Services

Table 4:

POOL AGE	<8	8 - 10	10 - 13	13 - 16	16 - 20	20+	ALL
Jan-09	21 Mos.	27 Mos.	23 Mos.	59 Mos.	42 Mos.	47 Mos.	39 Mos.
Feb-09	21 Mos.	27 Mos.	23 Mos.	59 Mos.	43 Mos.	47 Mos.	40 Mos.
Mar-09	21 Mos.	28 Mos.	24 Mos.	60 Mos.	43 Mos.	47 Mos.	40 Mos.
Apr-09	22 Mos.	27 Mos.	25 Mos.	61 Mos.	43 Mos.	47 Mos.	41 Mos.
May-09	22 Mos.	27 Mos.	26 Mos.	62 Mos.	43 Mos.	48 Mos.	41 Mos.
Jun-09	23 Mos.	28 Mos.	26 Mos.	62 Mos.	43 Mos.	48 Mos.	42 Mos.
Jul-09	23 Mos.	26 Mos.	27 Mos.	63 Mos.	44 Mos.	49 Mos.	42 Mos.
Aug-09	23 Mos.	26 Mos.	27 Mos.	62 Mos.	44 Mos.	49 Mos.	42 Mos.
Sep-09	23 Mos.	26 Mos.	28 Mos.	63 Mos.	45 Mos.	49 Mos.	42 Mos.
Oct-09	23 Mos.	26 Mos.	28 Mos.	63 Mos.	45 Mos.	49 Mos.	43 Mos.
Nov-09	23 Mos.	27 Mos.	29 Mos.	64 Mos.	45 Mos.	49 Mos.	43 Mos.

2009 pool age broken out by maturity sector. Source: Colson Services

YEAR-TO-DATE CPR DATA

Table 5:

< 8 BY AGE	0-12 Mos.	13-24 Mos.	25-36 Mos.	37-48 Mos.	48+ Mos.
Jan-09	7.35%	31.58%	10.94%	15.95%	2.41%
Feb-09	13.53%	10.26%	6.52%	4.50%	21.72%
Mar-09	9.36%	19.91%	14.43%	15.20%	18.36%
Apr-09	16.19%	11.44%	8.89%	5.24%	6.89%
May-09	14.49%	13.28%	6.28%	10.88%	10.10%
Jun-09	15.17%	12.41%	11.87%	18.19%	6.68%
Jul-09	10.01%	15.56%	12.53%	11.63%	2.41%
Aug-09	12.34%	24.72%	14.14%	13.62%	4.13%
Sep-09	6.94%	12.85%	15.51%	9.56%	5.18%
Oct-09	9.34%	12.72%	9.70%	1.40%	16.91%
Nov-09	7.14%	15.83%	8.03%	6.71%	7.61%
Grand Total	11.22%	16.84%	10.85%	10.15%	9.41%

10-13 BY AGE	0-12 Mos.	13-24 Mos.	25-36 Mos.	37-48 Mos.	48+ Mos.
Jan-09	9.56%	13.20%	7.40%	8.64%	8.76%
Feb-09	10.87%	16.62%	12.39%	8.83%	11.78%
Mar-09	11.51%	14.64%	9.99%	5.24%	7.45%
Apr-09	7.86%	20.69%	12.62%	15.73%	6.49%
May-09	11.87%	17.74%	12.49%	9.50%	8.90%
Jun-09	13.83%	14.17%	10.21%	7.70%	5.97%
Jul-09	9.11%	15.37%	9.97%	7.13%	7.17%
Aug-09	9.06%	16.91%	11.24%	7.60%	10.44%
Sep-09	6.98%	11.03%	7.88%	3.41%	6.51%
Oct-09	9.17%	14.66%	13.24%	7.53%	5.26%
Nov-09	6.08%	18.90%	9.56%	10.40%	6.13%
Grand Total	9.90%	15.84%	10.66%	8.23%	7.68%

16-20 BY AGE	0-12 Mos.	13-24 Mos.	25-36 Mos.	37-48 Mos.	48+ Mos.
Jan-09	5.25%	6.38%	17.21%	6.73%	10.29%
Feb-09	0.00%	13.17%	5.76%	4.81%	12.03%
Mar-09	8.52%	19.83%	4.91%	10.43%	12.05%
Apr-09	6.41%	2.64%	5.11%	0.89%	12.02%
May-09	1.01%	8.14%	14.23%	10.61%	13.93%
Jun-09	1.10%	5.73%	10.50%	0.77%	5.97%
Jul-09	0.00%	4.86%	10.76%	2.32%	7.30%
Aug-09	0.00%	2.82%	8.80%	1.93%	3.05%
Sep-09	14.33%	12.78%	7.03%	1.94%	6.72%
Oct-09	3.75%	17.13%	24.21%	10.87%	6.73%
Nov-09	3.56%	5.76%	7.05%	6.19%	5.67%
Grand Total	4.05%	9.23%	10.96%	5.20%	8.68%

YEAR-TO-DATE CPR DATA

Table 6:

8-10 BY AGE	0-12 Mos.	13-24 Mos.	25-36 Mos.	37-48 Mos.	48+ Mos.
Jan-09	7.89%	12.32%	8.52%	3.96%	12.50%
Feb-09	11.59%	11.43%	15.08%	5.57%	12.29%
Mar-09	11.28%	22.85%	10.72%	10.13%	12.67%
Apr-09	12.82%	21.12%	11.37%	5.64%	7.08%
May-09	11.09%	21.71%	8.76%	6.27%	10.23%
Jun-09	6.57%	16.04%	8.81%	6.67%	10.70%
Jul-09	5.85%	18.36%	8.90%	5.97%	8.92%
Aug-09	14.14%	23.41%	8.80%	5.77%	9.32%
Sep-09	5.03%	6.72%	4.71%	5.23%	4.31%
Oct-09	10.56%	17.51%	16.67%	4.28%	10.54%
Nov-09	13.42%	15.68%	13.08%	6.39%	6.47%
Grand Total	10.05%	17.19%	10.66%	6.07%	9.50%

13-16 BY AGE	0-12 Mos.	13-24 Mos.	25-36 Mos.	37-48 Mos.	48+ Mos.
Jan-09	0.00%	9.70%	0.00%	10.03%	11.28%
Feb-09	20.67%	4.28%	0.00%	7.21%	7.03%
Mar-09	0.00%	2.39%	14.62%	5.15%	12.71%
Apr-09	8.89%	9.78%	0.00%	4.95%	10.55%
May-09	0.00%	32.61%	0.00%	6.13%	8.85%
Jun-09	0.00%	15.88%	0.55%	4.14%	7.32%
Jul-09	0.00%	0.00%	29.55%	11.09%	9.84%
Aug-09	0.00%	0.00%	0.00%	3.25%	4.42%
Sep-09	0.00%	5.76%	11.26%	1.25%	7.53%
Oct-09	25.31%	7.87%	5.85%	0.00%	6.71%
Nov-09	0.00%	0.00%	0.00%	41.24%	7.40%
Grand Total	5.86%	7.27%	6.99%	6.63%	8.41%

20+ BY AGE	0-12 Mos.	13-24 Mos.	25-36 Mos.	37-48 Mos.	48+ Mos.
Jan-09	10.77%	12.40%	10.16%	7.43%	8.21%
Feb-09	3.56%	6.57%	12.17%	5.72%	9.25%
Mar-09	6.12%	9.38%	7.45%	5.64%	7.61%
Apr-09	7.53%	12.23%	10.84%	5.36%	7.91%
May-09	6.47%	9.24%	10.55%	4.41%	7.66%
Jun-09	5.38%	9.05%	5.77%	1.86%	7.58%
Jul-09	3.75%	5.89%	6.95%	6.22%	5.59%
Aug-09	2.53%	9.86%	9.15%	6.66%	6.61%
Sep-09	3.39%	8.33%	6.48%	4.17%	5.04%
Oct-09	3.07%	13.70%	11.53%	6.90%	6.35%
Nov-09	2.32%	7.30%	5.99%	5.93%	4.19%
Grand Total	5.06%	9.47%	8.96%	5.45%	6.84%

GLOSSARY AND DEFINITIONS: PART 1

Default-Curtailment Ratio

The Default-Curtailment Ratio (DCR), or the percentage of secondary loan curtailments that are attributable to defaults, can be considered a measurement of the health of small business in the U.S. GLS, with default and borrower prepayment data supplied by Colson Services, has calculated DCRs for both SBA 7(a) and 504 loans since January, 2000.

The default ratio is calculated using the following formula:

$$\text{Defaults} / (\text{Defaults} + \text{Prepayments})$$

By definition, when the DCR is increasing, defaults are increasing faster than borrower prepayments, suggesting a difficult business environment for small business, perhaps even recessionary conditions. On the flip side, when the DCR is decreasing, either defaults are falling or borrower prepayments are outpacing defaults, each suggesting improving business conditions for small business.

Our research suggests that a reading of 20% or greater on 7(a) DCRs and 15% or greater on 504 DCRs suggest economic weakness in these small business borrower groups.

Theoretical Default Rate

Due to a lack of up-to-date default data, we attempt to estimate the current default rate utilizing two datasets that we track:

1. Total prepayment data on all SBA pools going back to 2003. This is the basis for our monthly prepayment information.

Total prepayment data on all secondary market 7(a) loans going back to 1999, broken down by defaults and voluntary prepayments. This is the basis for our monthly default ratio analysis.

With these two datasets, it is possible to derive a theoretical default rate on SBA 7(a) loans. We say “theoretical” because the reader has to accept the following assumptions as true:

1. The ratio of defaults to total prepayments is approximately the same for SBA 7(a) pools and secondary market 7(a) loans.

Fact: 60% to 70% of all secondary market 7(a) loans are inside SBA pools.

2. The default rate for secondary market 7(a) loans closely approximates the default rate for all outstanding 7(a) loans.

Fact: 25% to 35% of all outstanding 7(a) loans have been sold into the secondary market.

While the above assumptions seem valid, there exists some unknown margin for error in the resulting analysis. However, that does not invalidate the potential value of the information to the SBA lender community.

The Process

To begin, we calculated total SBA pool prepayments, as a percentage of total secondary loan prepayments, using the following formula:

$$\text{Pool Prepay Percentage} = \text{Pool Prepayments} / \text{Secondary Loan Prepayments}$$

This tells us the percentage of prepayments that are coming from loans that have been pooled. Next, we calculated the theoretical default rate using the following equation:

$$((\text{Secondary Loan Defaults} * \text{Pool Prepay Percentage}) / \text{Pool Opening Balance}) * 12$$

This provides us with the theoretical default rate for SBA 7(a) loans, expressed as an annualized percentage.

GLS Long Value Indices

Utilizing the same maturity buckets as in our CPR analysis, we calculate 6 separate indexes, denoted as GLS VI-1 to VI-6. The numbers equate to our maturity buckets in increasing order, with VI-1 as <8 years, VI-2 as 8-10 years, VI-3 as 10-13 years, VI-4 as 13-16 years, VI-5 as 16-20 years and ending with VI-6 as 20+ years.

The new Indices are basically weighted-average spreads to Libor, using the rolling six-month CPR for pools in the same maturity bucket, at the time of the transaction. While lifetime prepayment speeds would likely be lower for new loans entering the secondary market, utilizing six-month rolling pool speeds allowed us to make relative value judgments across different time periods.

We compare the bond-equivalent yields to the relevant Libor rate at the time of the transaction. We then break the transactions into the six different maturity buckets and calculate the average Libor spread, weighting them by the loan size.

For these indices, the value can be viewed as the average spread to Libor, with a higher number equating to greater value in the trading levels of SBA 7(a) loans.

GLOSSARY AND DEFINITIONS: PART 2

Prepayment Calculations

SBA Pool prepayment speeds are calculated using the industry convention of Conditional Prepayment Rate, or CPR. CPR is the annualized percentage of the outstanding balance of a pool that is expected to prepay in a given period. For example, a 10% CPR suggests that 10% of the current balance of a pool will prepay each year.

When reporting prepayment data, we break it into seven different original maturity categories: <8 years, 8-10 years, 10-13 years, 13-16 years, 16-20 years and 20+ years. Within these categories we provide monthly CPR and YTD values.

In order to get a sense as to timing of prepayments during a pool's life, we provide CPR for maturity categories broken down by five different age categories: 0-12 months, 13-24 months, 25-36 months, 37-48 months and 48+ months.

As to the causes of prepayments, we provide a graph which shows prepayment speeds broken down by voluntary borrower prepayment speeds, denoted VCPR and default prepayment speeds, denoted as DCPR. The formula for Total CPR is as follows:

$$\text{Total Pool CPR} = \text{VCPR} + \text{DCPR}$$

SBA Libor Base Rate

The SBA Libor Base Rate is set on the first business day of the month utilizing one-month LIBOR, as published in a national financial newspaper or website, plus 3% (300 basis points). The rate will be rounded to two digits with .004 being rounded down and .005 being rounded up.

Please note that the SBA's maximum 7(a) interest rates continue to apply to SBA base rates: Lenders may charge up to 2.25% above the base rate for maturities under seven years and up to 2.75% above the base rate for maturities of seven years or more, with rates 2% higher for loans of \$25,000 or less and 1% higher for loans between \$25,000 and \$50,000. (Allowable interest rates are slightly higher for SBAExpress loans.)

Risk Types

The various risk types that impact SBA pools are the following:

Basis Risk: The risk of unexpected movements between two indices. The impact of this type of risk was shown in the decrease in the Prime/Libor spread experienced in 2007 and 2008.

Prepayment Risk: The risk of principal prepayments due to borrower voluntary curtailments and defaults. Overall prepayments are expressed in CPR, or Conditional Prepayment Rate.

Interest Rate Risk: The risk of changes in the value of an interest-bearing asset due to movements in interest rates. For pools with monthly or quarterly adjustments, this risk is low.

Credit Risk: Losses experienced due to the default of collateral underlying a security. Since SBA loans and pools are guaranteed by the US government, this risk is very small.

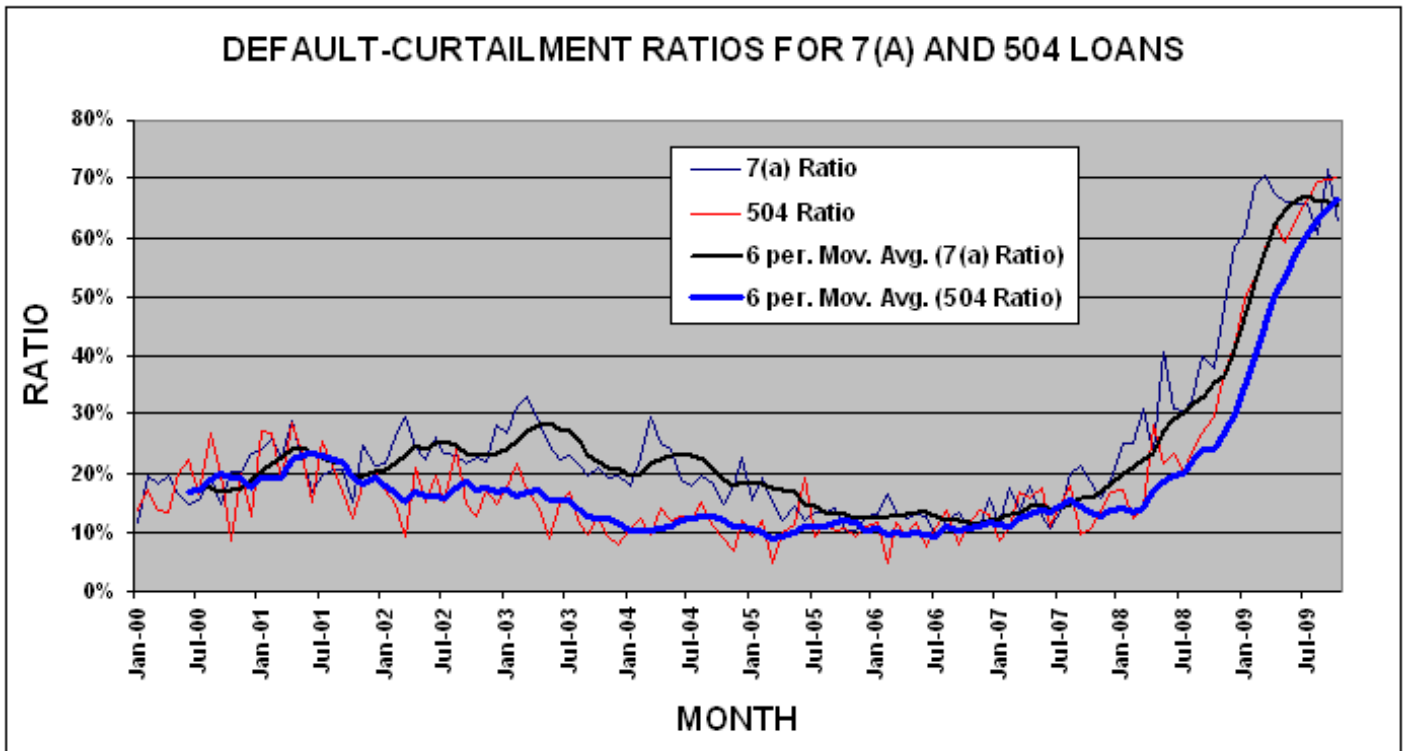
TALF

The TALF, or **Term Asset-Backed Security Loan Facility**, was announced by the Federal Reserve Bank and the US Treasury on November 25, 2008. The purpose of the TALF is to make credit available to consumers and small businesses on more favorable terms by facilitating the issuance of asset-backed securities (ABS) and improving the market conditions for ABS more generally.

The most recent update was released by the Federal Reserve on May 19th, 2009.

The Federal Reserve Bank of New York will make up to \$1 trillion of loans under the TALF. TALF loans will have a term of three years; will be non-recourse to the borrower; and will be fully secured by eligible ABS. The US Treasury Department will provide \$100 billion of credit protection to the Federal Reserve in connection with the TALF.

SBA Pools issued in 2008 and beyond are considered eligible securities. SBA Pools are eligible for 3 or 5 year TALF loans.



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Government Loan Solutions, Inc. (GLS) was founded by three former Bond Traders in Cleveland, OH. Scott Evans, Rob Herrick and Bob Judge possess a combined 70 years experience in the institutional fixed income markets, 40 of which are in the SBA securitization business. GLS formally began operations in January, 2007. Our mission is as follows:

"The purpose of Government Loan Solutions is to bring greater efficiency, productivity and transparency to the financial markets. Through the use of proprietary technology, we intend to aid lenders in all aspects of their government lending, help pool assemblers be more productive in their operational procedures and provide quality research to the investor community."

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FINANCIAL INSTITUTIONS

Updated: February 12, 2010

ACCOUNTING FOR TRANSFERS OF FINANCIAL ASSETS

FAS No. 166, *Accounting for Transfers of Financial Assets*, is effective for transfers of financial assets (e.g., loans) that occur after the beginning of an entity's first annual reporting period beginning after November 15, 2009 (transfers on or after January 1, 2010, for calendar-year entities). FAS No. 166 can be found in its entirety at www.fasb.org under "Pre-Codification Standards" in the Standards menu.

In June 2009, the Financial Accounting Standards Board (FASB) issued a new accounting standard (Financial Accounting Standard No. 166) that amends previous guidance on accounting for transfers of financial assets. This standard is effective as of the beginning of an entity's first annual reporting period beginning after November 15, 2009 (for calendar-year entities, it will be effective January 1, 2010).

This new standard will change current accounting practices in two very significant ways:

- The concept of a qualifying special-purpose entity (QSPE) and the exception from applying the accounting guidance on consolidation of variable interest entities to QSPEs is now removed from accounting standards.
- If an entity transfers a portion of a financial asset rather than the entire financial asset, the standard will limit when the transfer will qualify as a sale and consequently when the institution will be able to remove the asset from its financial statements and recognize any gain or loss on sale.

ELIMINATION OF THE QUALIFYING SPECIAL-PURPOSE ENTITY

Prior to this new guidance, institutions could set up a QSPE, transfer assets to this entity, and automatically disregard this entity when preparing consolidated financial statements, thereby removing the assets from the institution's balance sheet. A common example of this occurs when loans are securitized. The institution will transfer the loans to a QSPE and issue securities that are collateralized by the loans in the QSPE. Since the loans are removed from the institution's balance sheet, the institution has renewed capacity to originate or purchase additional loans.

After adoption of this new standard, such institutions will have to consider the consolidation requirements of variable interest entities to determine whether a QSPE can be disregarded or must be included in the institution's consolidated financial statements.

While there are several important issues that will impact institutions with QSPEs, this Accounting Insight will not address these issues. Instead, this Accounting Insight focuses on the impact to institutions that transfer a portion of a financial asset through loan participations sold.

PARTICIPATIONS SOLD

When an institution transfers an entire financial asset (for example, the sale of a fixed-rate mortgage loan to the secondary market), the institution can treat this transfer as a sale and remove the asset from its own balance sheet if and only if the following conditions are met (ASC 860-10-40-5, as amended):

- The transferred financial asset is isolated from the selling institution – that is, put presumptively beyond the reach of the selling institution and its creditors, even in bankruptcy or other receivership.
- Each transferee has the right to pledge or exchange the assets it received.
- The selling institution does not maintain effective control over the transferred financial asset.

These requirements remain largely unchanged from previous accounting guidance.

However, the new accounting guidance may significantly impact institutions that transfer a portion of a financial asset. A common example of this occurs when an institution sells a participation in a loan (“participation sold”). Participations sold may include a variety of terms, but in its simplest form, an institution will sell a specific percent of a loan originated by the institution to a third party. As the borrower makes payments on the original loan, the institution remits a pro rata amount of each payment less a servicing fee to the third party.

When an institution does not sell an entire financial asset, as is the case with a participation sold, it must meet the above requirements and the additional criteria of a “participating interest” to be treated as a sale. A participating interest has all of the following characteristics:

- From the date of the transfer, the sold portion represents a proportionate (pro rata) ownership interest in an entire financial asset.
- From the date of the transfer, all cash flows received from the entire financial asset are divided proportionately among the participating interest holders in an amount equal to their share of ownership.
- The rights of each participating interest holder (including the selling institution in its role as a participating interest holder) have the same priority, and no participating interest holder’s interest is subordinated to the interest of another participating interest holder.
 - As part of this requirement, participating interest holders have no recourse to the selling institution or to each other (normal servicing arrangements do not violate this requirement).
- No party has the right to pledge or exchange the entire financial asset unless all participating interest holders agree to pledge or exchange the entire financial asset.

SALES VERSUS SECURED BORROWING TRANSACTIONS

If sale treatment is permitted for a transfer of financial assets, such as a participation sold, the institution benefits by being able to reduce its loans for the portion of the loan sold and to recognize any applicable gain on sale at the time of the transfer.

If a transfer of a financial asset does not qualify for sale treatment, the transferring institution continues to recognize the asset on its own balance sheet, records a secured borrowing (liability) with a pledge of collateral, and is not permitted to recognize any gain on sale. Accounting Standards Codification (ASC) 860-30 includes accounting guidance on how the transferor and transferee should account for a secured borrowing.

A secured borrowing transaction has less favorable regulatory treatment than a sale, too. If sale treatment is allowed, the participation sold is removed from the loan portfolio, which has the effect of improving regulatory capital ratios. Since the institution continues to recognize the entire loan as an asset in a secured borrowing transaction, such transactions do not improve regulatory capital ratios. In addition, if sale treatment is not allowed for a participation sold and the loan balance is not reduced, the institution cannot use the participation sold to reduce large loan balances below the institution's legal lending limit.

PROBLEM TERMS IN PARTICIPATION SOLD AGREEMENTS

The new guidance will be effective for participations sold and other transfers of financial assets that occur after the institution is required to adopt the guidance. Thus, institutions will not have to evaluate participations sold currently in effect, although they will have to evaluate the arrangements if they are renewed or modified after the effective date of the accounting standard.

Although not a complete list, the following are some common scenarios that will likely disqualify an institution from using sale treatment:

- **Line of credit participation** – Some institutions have participated interests in lines of credit or other loans whereby the selling institution funds the first draws up to a certain dollar amount and then participates the remaining draws as they are made. This is not a proportionate ownership in the loan and does not qualify as a sale under the new accounting standard. To qualify as a sale, this arrangement could be modified to participate all draws proportionately to all of the participants as the draws are made.
- **Last in, first out and similar arrangements** – In some participation sold agreements, all of the first payments from the borrower are passed along to the participating interest holders and the selling institution receives the remaining payments after the participating interest holders have been paid off. This results in disproportionate cash flows and disallows the use of sale treatment. The arrangement could qualify for sale treatment if, instead, it required all payments received by the selling institution be divided equally among the participating interest holders, including the selling institution.
- **Excessive servicing fees** – Some institutions retain a fee for servicing the loan that is significantly higher than the fee that would fairly compensate the institution for its servicing obligation. This also results in a disproportionate division of cash flows among the participating interest holders. To qualify as a sale, the selling institution could modify the arrangement so that it retains a servicing fee that fairly compensates it for servicing the loan.

PROBLEM TERMS IN PARTICIPATION SOLD AGREEMENTS (CONTINUED)

- **Interest-only strips** – In some cases, the contractual interest rate of the loan exceeds the market rate at the time of transfer. The participation agreement may include a provision that the selling institution will only pass along the market interest rate to the participating interest holders and retain the excess interest, which usually results in the recognition of an interest-only strip and disqualifies sale treatment. (This is especially common with sales of the guaranteed portion of SBA loans.) The institution may qualify for sale treatment if it charged a premium to the participating interest holders at the transfer date to compensate for the above-market interest and then remitted the full contractual interest amounts (less applicable servicing fees) to the participants as they are received from the borrower.
- **Recourse obligations** – Most recourse provisions will disqualify the use of sale treatment for participations sold. Examples of recourse obligations include an agreement that the selling institution will repurchase loans that default within 90 days of sale or refund any premium paid by the participating interest holder if the loan is prepaid within a defined time frame. If the recourse provision expires, the institution can reevaluate the participation agreement to determine if it subsequently meets the participating interest criteria.

CONCLUDING THOUGHTS

This guidance applies to all transfers that occur on or after the beginning of an entity's first annual reporting period beginning after November 15, 2009 (January 1, 2010, for calendar-year entities). The standard does not impact loan participations sold prior to this date where the only activity related to the participation is the remittance of payments. However, this standard will affect new draws on lines of credit that are participated out since these are new transfers, even though the participation agreement was entered into prior to the effective date of the standard. In addition, it appears this standard will affect loan participation renewals and extensions occurring after the effective date.

The new accounting guidance issued for transfers of financial assets may have a significant impact on financial institutions that sell loan participations to other parties. We recommend management become familiar with this new guidance and train those that work directly with loan participations sold to identify terms of participation agreements that could disqualify the institution from using sale treatment.

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Please check our website (www.wipfli.com) regularly for current updates!