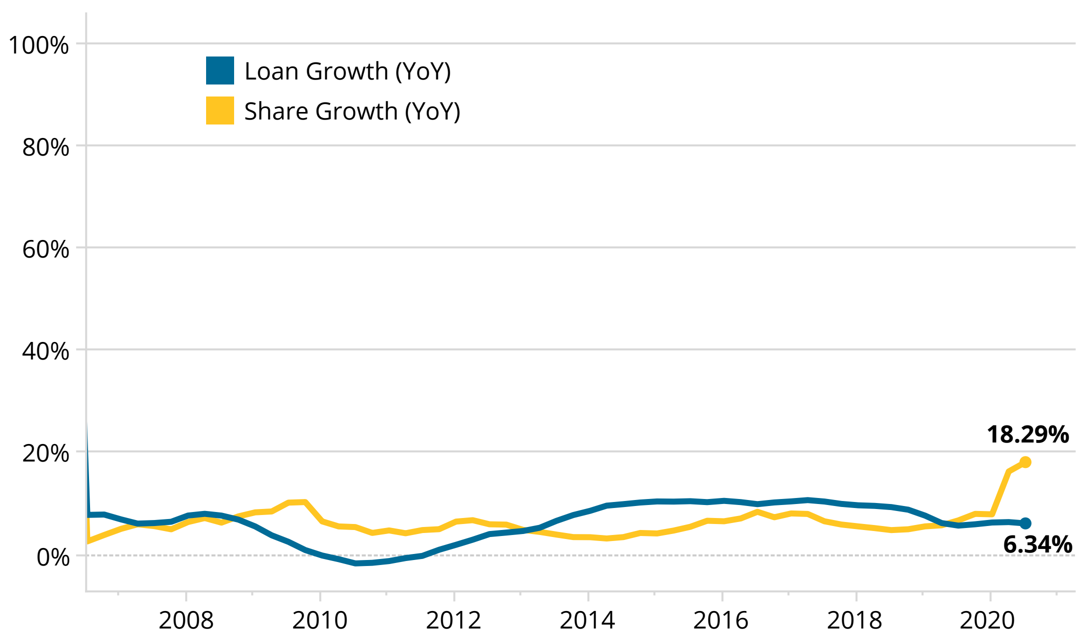
The Next Generation of Loan Participations

An Evolving Tool for Balance Sheet Management

Amid low interest rates and a surge in deposits, it's time for credit unions and banks to re-examine the traditional balance sheet optimization toolkit.

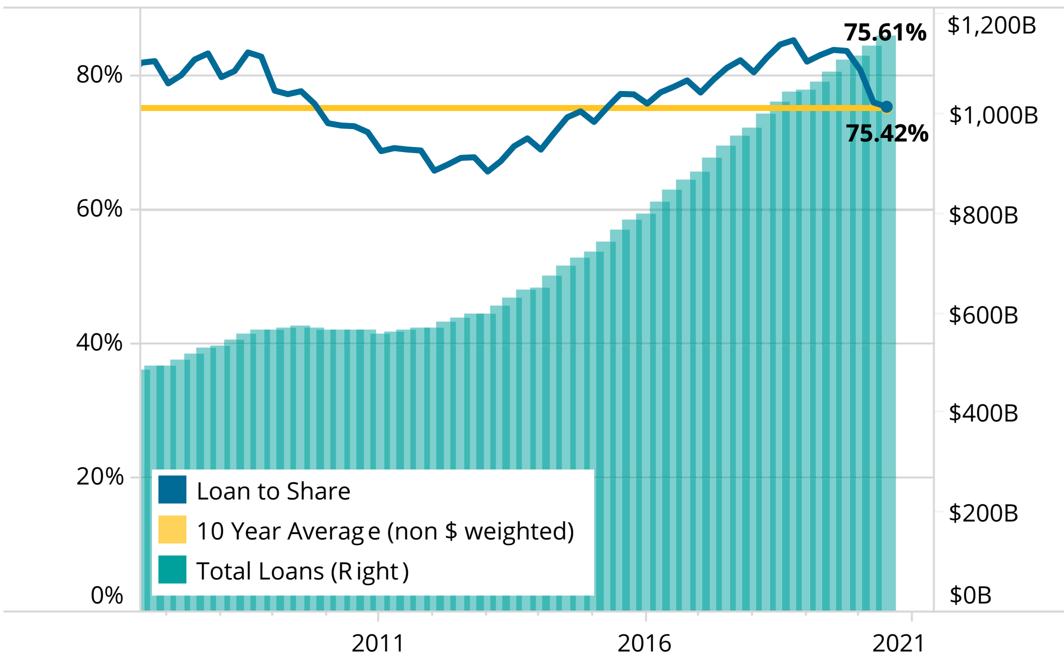
Ten years ago, when LendKey began serving clients in the wake of the Great Recession, credit unions and banks were flush with deposits but had few opportunities to grow originations or accumulate assets. Today's environment is similar, but available solutions have evolved — especially in the area of loan participations.

Loan Growth vs. Share Growth



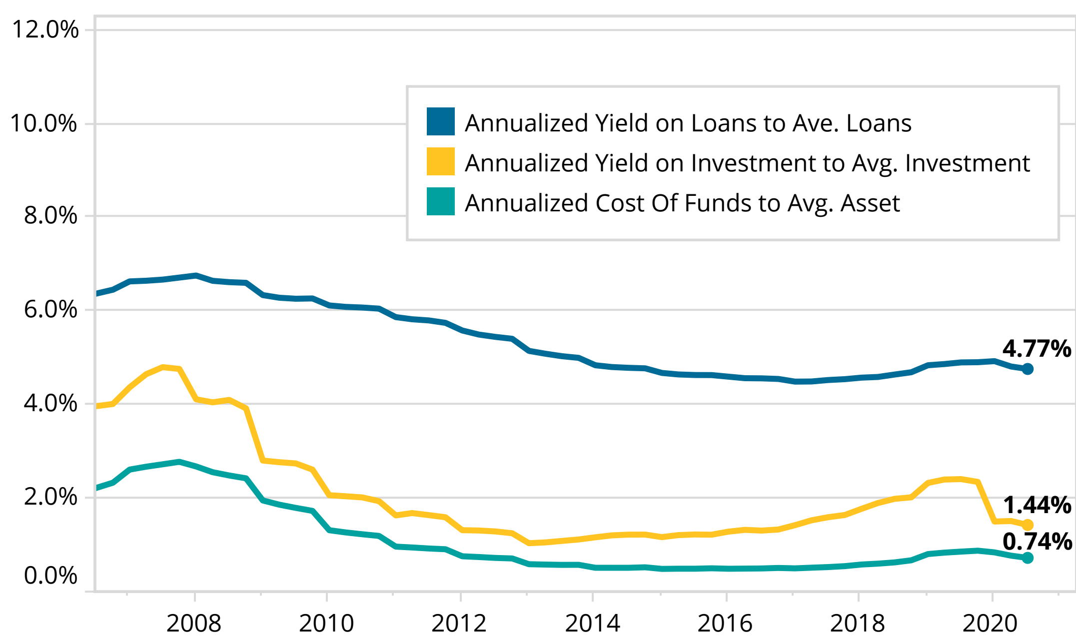
(Source: NCUA National Trends Report.)

Total Loans / Total Shares



(Share growth spiked in 2020, while loan growth remained stagnant, a dynamic last seen in 2009-2010 after the Great Recession; loan-to-share among credit unions has plummeted. Source: NCUA National Trends Report.)

Yield vs. Cost of Funds



(Meanwhile, yield on loans is near decade lows, while yield on investment has dropped sharply as interest rates dropped during the COVID recession. Source: NCUA National Trends Report.)

As deposit bases swell, interest rates remain low, and origination opportunities shrink, financial institutions should consider the increasing benefits of loan participations. Participations allow the sharing of loans among multiple institutions, giving credit unions access to new, diversified sources of attractive interest income.

Loan participations aren't new, but they've evolved over time — with LendKey at the forefront of that evolution. As such, LendKey is pleased to introduce its latest offering, Aliro. Aliro is a private deal network for buying and selling loans, featuring loan participation services with a proprietary forward flow structure.

Key Takeaways

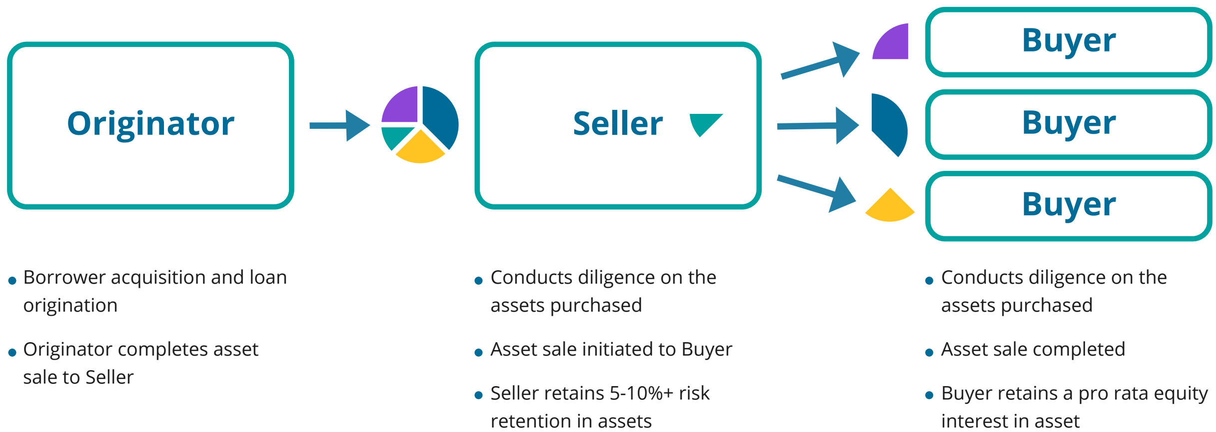
- Technological innovation has reduced the historical frictions and costs associated with loan participations.
- Buyers of loan participations earn returns on assets without having to undertake the same marketing, research, and servicing processes that accompany in-house origination. Aliro further smoothes the process for buyers by centralizing loan documentation and payment processing within a single system.
- Sellers of loan participations can reduce the in-house manual administrative effort, manage portfolio risk, and earn non-interest income via loan sale premiums or loan servicing fees.
- "Forward flow" enables both buyers and sellers to better plan and anticipate supply and demand in the lending marketplace through recurring loan participations.

LOAN PARTICIPATIONS

A Refresher

Loan participations have a long history in the U.S. With roots in trust agreements and bilateral contracts among banks, participations had become a meaningful contributor to savings and loan profits by the mid-1960s. The transaction gained additional prevalence in the following decades. The FDIC and NCUA's guidance on modern participations, a response to the housing boom and bust, got its last major update in 2013. Today, credit unions alone undertake around $15 billion in loan participations annually.

A loan participation starts with a standard loan process, where an originator lends money to a borrower. In a traditional participation, the originator then sells partial interest in the loan to buyer institutions. More recently, though, marketplace lenders have served as third-party origination sources who then work with a "seller" institution. The seller takes the loan on its own balance sheet and sells partial interests to the buyers. (Note: only the selling institution needs to effectively memberize the borrower; buyers of loan participations do not need to take this step.) Regardless, the entity that sells a loan participation keeps some interest in the original loan — usually at least 10% for risk retention purposes.



(This is an illustrative example where the selling financial institution is not the initial originator of the loan.)

LOAN PARTICIPATIONS

Then and Now

Loan participations have undergone meaningful changes in the past decade that have reduced frictions and enabled a more versatile process for buyers as well as sellers. Credit unions and banks should be aware of these changes as they contemplate options for expanding their asset bases and targeting optimal returns.

Loan Participations Then

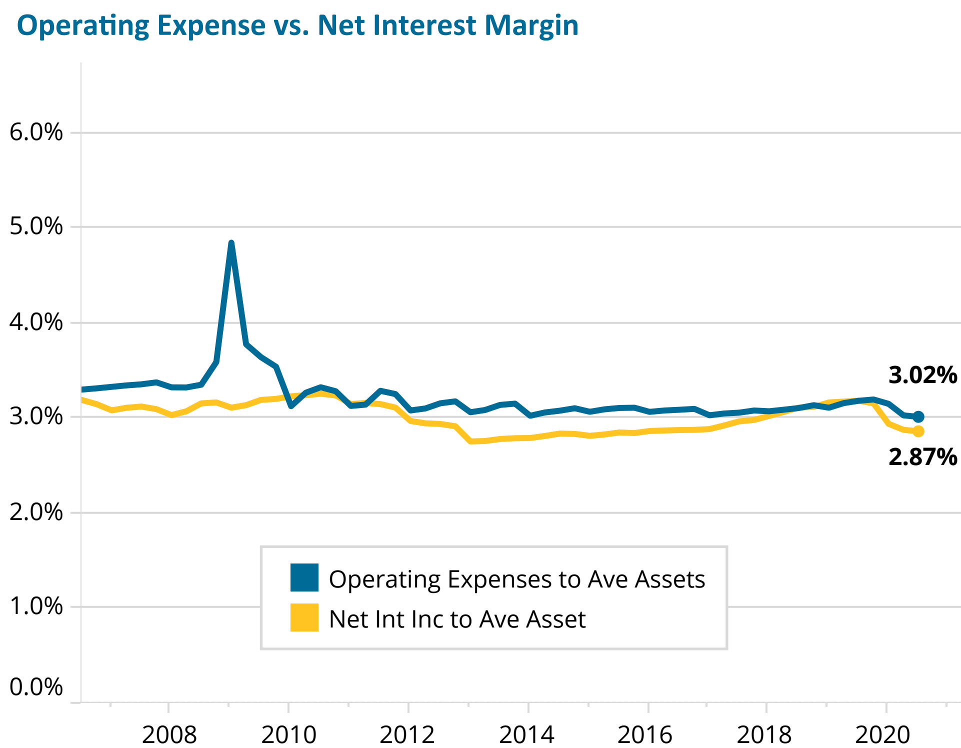
Although credit unions and banks have been using loan participations to manage asset growth and portfolio risk for a long time, a few key drawbacks tend to keep institutions from embracing the practice as much as they could.

For one thing, brokers have historically been the predominant way to access participations, and, as a result, the market has had a tendency to be fractured and inefficient. Each transaction could have its own idiosyncratic process, making it difficult for credit unions and banks to transact in participations.

Another challenge is that the onus is on the selling credit union or bank to handle ongoing accounting, reporting, and payment remittance functions for all investors in a given participation. This additional administrative burden has induced selling credit unions and banks to limit the number of buyers that they engage in transactions. Meanwhile, this damper on transaction volume meant originators sometimes had to reduce marketing activities or even turn away borrowers to keep their assets in line with regulatory requirements.

From the buyer's point of view, many smaller institutions lack the resources or expertise to manage loan participations. Institutions that do have capacity to buy participations often have to navigate inconsistent participation volume.

Taken altogether, these dynamics led to an artificially small market for participations and frequent reliance on small direct relationships among credit unions with close geographic ties or strong existing relationships. Although credit unions have historically found participations helpful on a case by case basis, their overall benefit was limited by market fragmentation and transaction costs. These limitations are especially challenging in today's environment, where credit unions and other institutions must carefully control operating expenses.



(Source: [NCUA National Trends Report.](#))

Loan Participations Now: A Way Forward With Aliro

Today, loan participations represent a less rigid and less labor-intensive solution for credit unions and banks that are looking to more dynamically manage their assets. Balance sheet management platforms like Aliro can help streamline the loan participation process, reducing costs and frictions among buyers and sellers. In general, loan participations conducted through Aliro tend to involve less paperwork and transaction costs, especially when considering its recurring nature. By providing much of the onboarding and diligence documentation directly on the platform, Aliro increases the loan participation process's viability as a portfolio solution.

Another key advantage of Aliro's system is its ability to handle the onboarding and diligence of new buyers. Today's loan participations involve less ongoing back-office workload and a more manageable diligence process. Aliro's system facilitates ongoing buyer reporting and payment remittance, allowing loan originators and sellers to grow their syndicate base with little to no marginal effort or resources.

The effect of this streamlining is a larger variety of loans available for sale and purchase through participations. Today, with an easier transaction process, more asset originators can enter the participation market, increasing the variety of loans available and making it easier for credit unions and banks to diversify their portfolios. Additionally, financial institutions can now more easily transact in smaller sizes -- amounts as low as $1 million are not uncommon. This can be a nice feature for participants who are looking to test the waters on a new type of asset or loan program.

The market for loan participations is growing -- it's now easier to achieve geographic diversification and participate in loans backed by distinct asset categories via participations. Marketplace lenders have been enthusiastically joining this revitalized ecosystem and looking for partners to participate out their loans, creating further opportunities for buyer and seller credit unions.

Technology platforms like Aliro are reducing the historical challenges associated with loan participations. Buyer diligence as well as ongoing buyer reporting and payment remittance has enabled originators, buyers, and sellers to participate more effectively in the market, creating new opportunities for credit unions and banks to effectively manage portfolio risk and return on assets.

Managing Income Streams with Forward-Flow

In addition to reducing the friction inherent in traditional loan participations, Aliro has capitalized on the changing loan participation market by creating “forward flow,” a system that allows buyers and sellers to take full advantage of the loan participation market’s increasing flexibility. Forward flow enables buyers to commit to loan purchases from a seller before the loans are originated. The result is increased income and balance sheet visibility for both parties.

Through forward flow, buyers receive a regular cadence of loan volume, consistent with their desired purchase commitment for each time period. This bundling process potentially reduces diligence frictions: After initial diligence on the loan vintage characteristics and seller has been completed, buyers can grow assets without relying on potentially challenging organic originations, low-yield investments, or expensive alternatives with inferior return on assets.

Meanwhile, sellers participating in forward flow receive a regular cadence of guaranteed loan purchases by trade-ready buyers. Sellers can buy or originate loans with confidence as their participation buyer syndicate grows over time, allowing for larger investments in direct marketing and customer acquisition.

Credit unions can think of forward flow similar to a subscription. The seller subscribes to a steady stream of demand for participation in interest-bearing investments, and the buyer subscribes to a steady stream of payments that fit its requirements.

Aliro’s forward flow is a natural outgrowth of the increased ease with which credit unions and banks can join in loan participations, and the increased diversity of available loans on the market. By creating a more stable stream of loan volume for both buyers and sellers, forward flow allows credit unions to fully benefit from changes in the loan participation marketplace.

Conclusion

As occurred in 2008 and 2009, credit unions once again have a large inventory of deposits with relatively limited opportunities to grow assets at attractive rates of return. Aliro solves this problem by expanding market access to diverse asset classes through loan participations, forward flow, and other balance sheet optimization services.

Loan participations remain an important tool in today's lending environment, just as they were a decade ago. Fortunately, many of the drawbacks associated with participations - ongoing accounting, reporting, and payment remittance obligations - have been greatly reduced, allowing more participants to enter the market and increasing the usefulness of participations to a larger number of credit unions. Aliro's forward flow system further capitalizes on these changes by creating a visible stream of loan supply and demand to the benefit of participation originators, buyers, and sellers alike.

About Aliro

*Aliro by LendKey provides a private deal network for trade-ready financial institutions looking to access capital and optimize their balance sheets. On the Aliro exchange, member firms can buy, sell, and broker a variety of asset classes with increased confidence, robust counterparty participation, and higher efficiency. LendKey has delivered more than $4 billion in total loans since its inception. More information can be found at **www.joinaliro.com**.*

Learn more

Chat with us to see how Aliro can work for your institution — email: **aliro@lendkey.com**.

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