LOANSTREET®

WHITE PAPER

What to Expect When You're Expecting Losses

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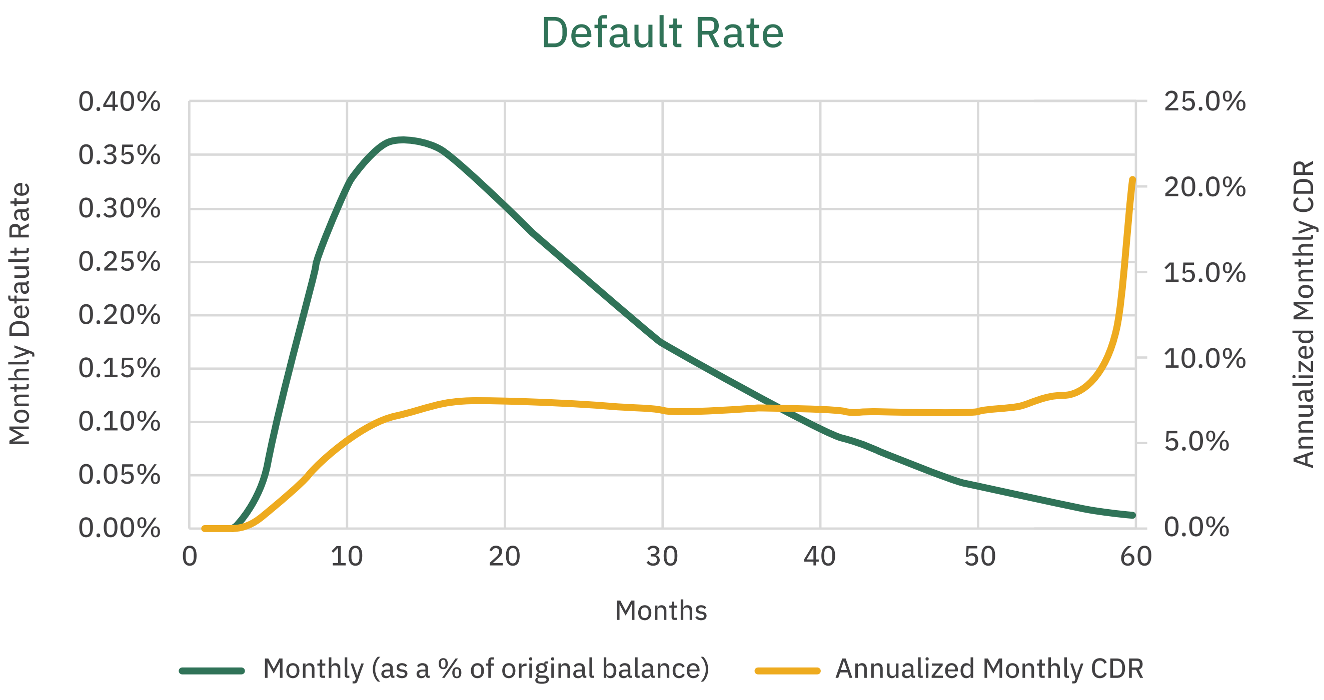
Introduction

Losses happen. No matter how stringent an originator's underwriting may be, loans will take losses. While some loan types, such as prime 15-year first-lien residential mortgages, may expect defaults to be rare and loss severities to be low, others, like unsecured consumer loans, should expect defaults to be more common with higher severities. In the latter case, understanding what these losses mean for the return profile is critical to managing expectations, especially for Boards of Directors, lending committees, regulators and auditors, who may be less familiar with each loan type and its behavior.

In Practice

As an example, consider a group of new, 60-month original term unsecured loans with an 8% coupon purchased at par. Let us assume the following loss-timing curve with a cumulative loss expectation of 9%. Note that at the tail end of the life of the loans, small losses turn into large constant default rates (CDR) due to the low remaining aggregate principal balance.

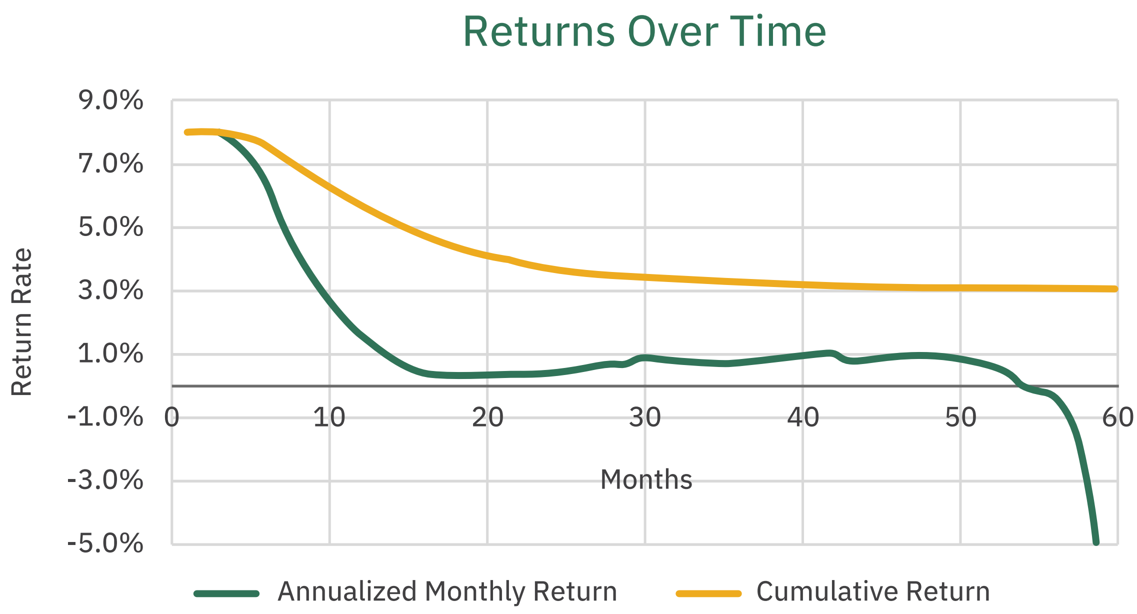
(As a reminder, loss-timing curves are derived using static pool analysis from loan-level performance. For more details on this methodology, see our previous article "Static Cling: Use Static Pool Analysis to Avoid Getting Shocked".)



Assuming a 20% Conditional Prepayment Rate (CPR), the weighted-average life of this set of loans will be approximately 1.8 years. With a 9% cumulative loss expectation, the annual losses will be approximately 5%, meaning the net, after-loss yield will be 3%. (Note that to keep things simple, all return and yield numbers are quoted on a monthly equivalent, rather than a semi-annual bond-equivalent basis.)

Importantly, the 3% annual lifetime return is not evenly distributed across time. With little or no losses in the early months, holders receive the full, unencumbered interest on the loans resulting in high monthly and life-to-date returns up to that point. However, once losses begin, net income declines, as do monthly and lifetime returns, with the lifetime return eventually reaching the expected 3% at the maturity of the loans.

The following graph displays the monthly return and cumulative Internal Rate of Return (IRR) of the loans as time passes. The IRR assumes no mark-to-market on the remaining loans, i.e., the remaining aggregate principal balance is valued at par at the end of each month.



As shown, early-month return outperformance compensates (or offsets) when losses are high and performance lags. While it's easy to forget this as those losses are peaking, since monthly returns can easily turn negative (especially in the real world where losses rarely follow an idealized, smooth curve), it's important to keep in mind the long-term end results - the lifetime return on the investment. Understanding this by using the necessary tools to properly track performance and returns over time becomes critical to presenting a more complete picture to all relevant stakeholders.

Conclusion

While one can never predict the exact timing of losses over the life of an investment, certain trends and patterns should generally be expected, along with their impact on returns. Short-term returns do not paint the full picture and it's important to keep in mind long-term results. Prioritizing these long-term results equips you with a more comprehensive understanding of the investment's return.

This approach, combined with tools such as performance analytics to accurately track returns over time, becomes critical to presenting a more complete picture to all relevant stakeholders. Calibrating your expectations allows you to enhance the confidence in your decision-making, particularly in the face of seemingly negative short-term results.

About LoanStreet

LoanStreet is the primary vehicle for financial institutions to share, report, and analyze their loan trading activities through an integrated, online platform. Our specialized software makes every step of the process as smooth as possible. From identifying your first pool of loans on the marketplace to receiving automated monthly consolidated reports, creating a seamless, scalable loan trading workflow has never been easier.

Get in touch to learn more about our platform. With over 1,300 financial institutions registered, we are ready to help you build a more efficient lending model.

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