



## Diversified Direct Lending Investments



**ANUP AGARWAL**  
18 Years Experience

Western Asset Management Company  
Head of MBS/ABS, 2013–

Stark Investments  
Portfolio Manager and Head of Consumer Credit, 2007–2013

Invesco Fixed Income  
Senior Manager, Head of Credit and Research, 2003–2007

Prudential Insurance/Questech Financial  
Principal, Senior Vice President, Capital Markets, 2001–2002

Copelco Capital, Inc./Citicorp Vendor Finance, Inc.  
Managing Director, Structured Finance 1998–2001

Moody's Investor Service  
Assistant Vice President, Credit Analyst, 1997–1998

Temple University,  
M.B.A. Finance

Indian Institute of Technology,  
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As the search for higher yielding investments moves increasingly toward illiquid investment opportunities, **Anup Agarwal, Head of MBS/ABS** and **Elliott Neumayer, Western Asset Product Specialist for Asset- and Mortgage-Backed products**, discuss opportunities in light of new global banking regulations that have constrained banks' ability to lend.

**Q: Could you give a brief background as to why the banks have moved away from certain lending channels?**

**EN:** Due to increased regulations stemming from Basel III, US and European banks of all sizes are now required to maintain higher capital ratios and greater liquidity as a safety measure. The risk-based capital ratios dramatically increase the risk-weighting of several asset classes, including non-standard mortgages and commercial and consumer loans, meaning banks' ability and desire to lend in these areas has fallen considerably, despite continued demand from borrowers.

The Dodd-Frank financial reform law in the US has also had a negative impact on banks' ability and willingness to lend. Banks of all sizes have reported increased costs to comply with Dodd-Frank, thereby driving up the cost of banking and lending to consumers and restricting the availability of financial products and credit. Regulators have missed statutory deadlines and made repeated revisions to proposed rules so lenders have been forced to prepare for the strictest standards fearing the forced buyback of loans. Therefore, most lenders have restricted their lending to fit within the narrowly defined "qualified mortgage" rules.

**Q: What opportunity does this offer to investors?**

**AA:** This lack of capital in the lending markets caused by the new banking regulatory framework has impacted all residential and commercial mortgage and consumer lending sectors in the US and in Europe. Investors that have the necessary resources and expertise can fill this void and acquire high quality loans offering attractive returns. Some direct lending strategies seek to originate loans directly to corporate entities. Western Asset's approach is different and focuses on working with established originators to acquire mortgage and consumer loans that conform to specified underwriting criteria across a range of sectors to achieve high quality lending at attractive rates. Some of the most interesting sectors include residential mortgages, private student loans, small balance commercial loans and mezzanine commercial real estate loans.

**Q: Many people are familiar with the credit crisis of 2008 that was predicated on poor quality lending. How have things changed?**

**EN:** Pre-crisis loans were characterized by very loose underwriting criteria, which resulted in loans that borrowers couldn't afford. For example, stated income and undocumented assets meant borrowers could state their income

<sup>1</sup> A qualified mortgage is a home loan that meets certain standards set forth by the federal government that went into effect in January 2014. Under qualified mortgage rules, these loans are in "safe harbor" and will be presumed to have met the Ability-to-Repay rule mandated by the Dodd-Frank Act. This provides legal protection for lenders against lawsuits by distressed borrowers who claim they were extended a mortgage the lender had no reason to believe they could repay.



**ELLIOTT R. NEUMAYER**  
12 Years Experience

Western Asset Management  
Company  
Product Specialist, 2004–

Marshall & Stevens  
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and assets without further verification by the mortgage originator. Furthermore, 100% loan-to-value (LTV) mortgages were available, meaning the borrower had no equity in the home. These and other loose underwriting criteria were a significant factor in the 2008 crisis as loans exhibited very high default and loss severity rates as soon as home prices started to drop.

Post-crisis, underwriting standards have become much more conservative due to the new regulatory and capital constraints and the fact that banks are still dealing with large inventories of distressed loans. Lender representation and warranties have been strengthened, so banks are worried about having to buy back bad loans for even the smallest documentation error in the loan files. Appraisal standards have also tightened and there is much more scrutiny on valuation methods, causing many appraisers to become very conservative. Many borrowers can afford to purchase new homes but they are held back due to a lack of mortgage availability. While underwriting standards clearly became too lax before the crisis, Western Asset believes the reaction has swung too far in the other direction and now many qualified borrowers are unable to access capital.

**Q: Given these opportunities, what can investors expect to achieve?**

**AA:** Asset- and mortgage-backed markets offer a range of opportunities for investors depending on the level of risk appetite and return objectives. At the conservative end of the risk spectrum are public market, liquid strategies with an emphasis on agency mortgage-backed securities (MBS) offering yields of around 2.0% to 3.0%. These markets are well established and as a result offer a limited yield pick-up over government securities.

There is a wider opportunity set as you move out the risk spectrum into lower quality and less liquid asset types such as non-agency residential MBS, commercial MBS and consumer ABS. These loans have been securitized and are issued in several rated tranches. These sectors offer a commensurately higher level of return, as well as some protection against rising rates due to the floating rate nature of many of the securities. These sectors were impacted considerably by the 2008 crisis but have since begun to function again. Yields in these sectors are typically around 4.0% to 5.0%.

Western Asset believes the most interesting opportunity is investing directly in the underlying loans in markets that have historically been served by banks and where lending is still constrained. Because of the lack of capital in these markets, Western Asset believes it can acquire these high quality loans at compelling rates. The diversified direct lending investment strategy seeks to provide attractive total returns with the use of leverage.

**Q: How is Western Asset approaching this market?**

**AA:** Western Asset believes there are considerable opportunities to invest in loans to creditworthy borrowers at attractive rates due to the lack of more traditional lenders in these areas. We have been working directly with established originators across a number of asset classes (private student loans and non-qualifying mortgages in the US) to purchase loans that conform to Western Asset's objectives. Our focus is on high-quality borrowers, for example those with high credit scores, good income levels and significant equity in their property for mortgages. Considerable due diligence is performed on the underlying loans to ensure they meet Western Asset's objectives.

Western Asset's direct lending investment approach is distinctive since we are pursuing a broad range of loan types within the residential, commercial and consumer sectors, and because we have relationships with multiple lenders across several loan categories. We can therefore look for the best opportunities that offer long-term fundamental value across all loan types and originators to find the best relative value for our investors. This is different from other direct lending strategies that might be focused on only one loan type. Other direct lending strategies might be managed by a firm that also owns an originator and only purchases their loans. We believe using a diversified pool of loans across various loan types can reduce risk for investors and allows Western Asset to take advantage of the best relative value opportunities.

### Q. If the quality of the underwriting is so critical, what due diligence does Western Asset do on the lenders it works with, and on the underlying loans?

**EN:** A strong infrastructure has been built to allow for the acquisition of loans from a multitude of different originators through a due diligence process which involves our Investment Management, Legal and Compliance, and Enterprise Risk Management departments. The US non-qualified-mortgage originator approval process includes a thorough review of the following items:

- Business Background/Composition
- Staff Training and Credentials
- Credit Review
- Product Offerings and Competitive Landscape
- Third Party Due Diligence
- Legal Landscape
- Compliance, Policies and Procedures, and Reporting
- Onsite Due Diligence Review

Western Asset's process for acquiring loans varies across loan types and our level of underwriting review varies as well depending on the underlying loan type. For US non-qualified-mortgage residential loans, Western Asset provides detailed underwriting criteria and pricing levels that loans must satisfy in order for us to approve purchasing the loans. Western Asset also hires a third party due diligence vendor to completely re-underwrite each US non-qualified-mortgage file to ensure conformance with the sellers' underwriting guidelines and standards at the time of origination.

If it is discovered during this loan file review process that any of Western Asset's criteria are not satisfied, there is no obligation to purchase the loans or, if purchased, we have the right to immediately put the loan back to the originator.

### Q. How does Western Asset ensure it is getting a high level of security on the lending?

**AA:** Western Asset places a great deal of emphasis on the high-quality underwriting criteria of the loans we are purchasing. The criteria vary by subsector to ensure a high level of security. For example, for mortgage loans, we focus on the underlying collateral valuation and, as described earlier, we will thoroughly review any appraisals and perform additional due diligence as needed. Western Asset is also only purchasing loans where the borrower has significant equity in the property. We will pass on higher yielding mortgages with very high LTVs and instead invest in lower but still attractive yields and lower LTVs. We believe that requiring significant borrower equity will incentivize borrowers to stay current on these loans and will also provide much higher recovery rates in the event of defaults.

### Q. Will Western Asset use leverage and what are the increased risks of using leverage on these loan structures?

**AA:** Western Asset's direct lending investment strategy can use leverage to get a more concentrated exposure to the underlying loans that have been issued. Higher returns could be achieved with less rigorous underwriting criteria, but we believe we can realize better returns for clients by emphasizing high quality lending, which we expect to result in fewer defaults on underlying loans. The quality of this underwriting is a key factor in why we feel it is appropriate to employ leverage.

The use of leverage has the ability to enhance returns but leverage can also magnify losses if the loans perform poorly. We believe we can mitigate this risk by investing in loans with solid underwriting and documentation and, in the case of mortgages, where the borrowers have significant equity in their properties and have shown they can afford their payments, but of course, risks cannot be eliminated.

Using repurchase financing (selling the loans with an agreement to repurchase at a set price at a later date) to achieve leverage can also introduce the risk of margin calls if the value of the loans declines. We intend to use only a portion of the amount of financing available to us, which would leave a significant cushion to absorb declines in asset valuations before any margin call is triggered. Repurchase financing is generally short term in nature and there is a risk that the financing costs will increase or that financing may be pulled altogether. While this is always a risk, given our extensive relationships with a wide variety of broker/dealers and other financial institutions, we believe we are able to retain access to the best financing terms available in the marketplace. This has certainly been one of the benefits of Western Asset's size—in light of reduced market liquidity, counterparties are focusing their resources on their most important relationships.

Where appropriate, we may also pursue longer-term financing options that will mitigate the re-pricing risk, such as lines of credit and term financing via the securitization market, although these options may not be available.

**Q. In what environment would Western Asset expect this strategy to perform best, and in what circumstances would the strategy be challenged?**

**EN:** Strong underwriting of high quality assets is the most critical factor in the success of this strategy and the collateral performance will ultimately drive the returns. The collateral should have the best performance in an environment of moderate global economic growth with a supportable, gradual rise in asset prices. A challenging environment would certainly be a decline in global growth with a severe decline in asset prices. We expect that given the high level of equity required in our loan investments, the recovery rates on any defaulted loans would be relatively high.

**Q. Why is now a good time?**

**AA:** Over time, we expect more lending channels to become available to borrowers who currently have limited opportunities to obtain credit. This limited availability of credit is the factor that is driving the attractive returns from conservative, well-underwritten loans. Over time, as more lenders enter the market, these returns will be squeezed.

Western Asset is well placed to take advantage of these lending opportunities today due to our existing relationships with originators and our expertise in these markets. We have been active in securitized markets since they first developed in the early 1970s. Finally, while capital flows into these sectors should dampen returns on future investments over time they should also help to provide liquidity to early investors seeking to crystallize returns.

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