



June 22, 2016

## **Poof! Alternative Lending is Gone**

By Alan Snyder

Recent news articles and related pundits are trumpeting the demise of alternative lending, particularly marketplace lending (AKA peer-to-peer). The assertion that these loans are “Level 3” assets as defined by The Financial Accounting Standards Board (“FASB”), with no visible comparative values (e.g., no liquid exchange pricing mechanism) is one complaint, yet is Chicken Little writ large. Many great investment opportunities meet the definition of Level 3 assets and can be counted in the billions, if not trillions (*viz.* most private equity, many structured debt products, etc.). In alternative lending, the crux of the issue is determining whether the actual rate of return at a point in time while loans remain outstanding truly reflects the ultimate return when all loans are either paid off or defaulted (including any recoveries). Fair value accounting demands that there is a valuation methodology for these generally illiquid assets, particularly when the expectation may be that they will not be held to maturity.

Aha, it now gets more interesting. Most alternative lending loans WILL be typically held to maturity, given their short life or duration, which for some might mean an intermediate valuation, is of little moment since variability could be high and the loans have little external and reliable market pricing mechanism. However, this conclusion is too facile because most investors demand a current valuation, particularly for pension plans or simply the need for their own financial reporting. *Moreover, discerning which lender uses which methodology is essential for any comparison of results between various lenders.* Currently, there are many different approaches in use, which makes this issue significant. Otherwise, it could become “pop goes the weasel” for the unwary investor who has selected a disastrously less attractive investment.

We will address some of the key considerations in any “mark-to-market” valuation methodology. Needless to say, we are mightily focused on this at Shinnecock in our evaluation of money managers and strategy mix. We don’t want to be Heraclitus noting that “no man ever steps in the same river twice,” but drive to consistent comparability as much as possible.

In short, it becomes “mark-to-model,” and ascertaining what the model variables might encompass. Some questions to ruminate on before digging into the evaluation of any model:

1. Will the loans be held to maturity?

2. What is the age of the portfolio, given that a recently acquired portfolio will usually have fewer defaults than one in mid-life or completely seasoned?
3. How do the portfolio interest rates compare to those of new loans being originated?
4. Is there available data for default experience and timing thereof, recovery rates for defaulted loans, differentiation by loan grade and strategy for key variables, prepayment histories, limitations from any secondary market on valuation caps, updated borrower data obtained after the date of original issuance, and more?
5. Is the investment vehicle open-ended, creating a valuation challenge between new investors participating in the existing portfolio versus those already invested and those who may be leaving?
6. What is the balance between realized and unrealized gains/losses, plus the manager's accounting policy for each?

The answers to these questions must guide the comparative analysis, whether a discounted cash flow model, loan loss reserve or some other valuation method. The weighting of these variables is best determined by investor preference. Many will quibble with that last observation, saying with certitude that truth is universal.

We disagree. A model is just that, based on a blend of relationships, future expectations and other assumptions. Some models mark-to-the-hereafter and become perceived as gospel. Does anyone remember VAR (Value At Risk) and the misconceptions it engendered? Moreover, sometimes simple is best in clarifying understanding.

Models are particularly useful when the inputs are varied to reflect what might happen. Stress testing allows for consideration of dire consequences. While generally not used yet, Monte Carlo simulations can establish parameters for the unexpected. At Shinnecock, we have used this approach at the portfolio level. Collecting key data elements, marking a portfolio and understanding the ramifications of "what if" scenario testing ain't easy, but important.

We have tried to be brief on a subject that could be explicated in a long treatise. Of course, we welcome the opportunity to amplify with any discussion/input/comments on this note.