SMALL BUSINESS

RESEARCH SUMMARY

No. 227
April 2003

An Exploration of a Secondary Market for Small Business Loans

by Kormendi/Gardner Partners, 2002
[33] pages. Washington, DC 20036
under contract no. SBAHQ-01-C-0150

Small business policymakers have seen the development of a secondary market for small business loans as a way of improving the flow of capital to entrepreneurs. In a secondary market, loans are pooled together and packaged as securities for sale to investors. This practice makes more capital available by allowing lending institutions to remove existing loans from their balance sheets, freeing them to make new loans.

To help stimulate the growth of a secondary market for conventional small business loans, Congress passed the Riegle Community Development and Regulatory Improvement Act in 1994. The law was intended to reduce the regulatory barriers to the securitization of conventional small business loans. Despite the Riegle Act, the growth of a secondary market for conventional small business loans has shown little progress during the past decade.

Several factors have hindered the emergence of a secondary market during the past decade. The two most important ones are the abundant supply of liquidity in the banking sector during the 1990s, which has reduced the need for extra liquidity from the public markets, and the lack of standardized loan underwriting practices, which has made it difficult to characterize the quality of the securities. This second condition may be changing however, because of two recent trends in the banking industry—the emergence of giant interstate bank holding companies and the increased use of credit scoring as the basis for loan approvals. The purpose of this report is to examine the extent to which these trends may make it easier for market participants to structure secondary market transactions that use conventional small business loans as collateral, and ultimately, to provide an additional source of liquidity for conventional small business lending.

Overall Findings

The authors found that the increasing use of credit scoring and the emergence of multibillion dollar bank holding companies in the U.S. banking sector have made the development of a secondary market for conventional small business loans more likely. There are two main reasons for this.

• First, the availability of a large pool of small business loans, especially small business credit lines and possibly small business credit card loans, provides a potential candidate for a secondary market since these loans have been underwritten with credit scoring models that are relatively standard across lenders.

• Second, since investment banks and rating agencies "underwrite the underwriters" rather than the loan pool alone, banking consolidation should improve the feasibility of the securitization of small business loans because of the emergence of large pools of loans available for securitization from fewer originators.

This *Small Business Research Summary* (ISSN 1076-8904) summarizes one of a series of research papers prepared under contracts issued by the U.S. Small Business Administration's Office of Advocacy. The opinions and recommendations of the authors of this study do not necessarily reflect official policies of the SBA or other agencies of the U.S. government. For more information, write to the Office of Advocacy at 409 Third Street S.W., Washington, DC 20416, or visit the office's Internet site at *www.sba.gov/advo.*

Highlights

The study found that many large lenders are using credit scoring to originate smaller loans, especially for lines of credit of $100,000 or less. While the application of credit scoring method in credit review may create problems for certain borrower groups, this development has resulted in a large pool of lines of credit that are good candidates for the secondary market because they are underwritten with relatively standard scoring methods across lenders.

Since most major small business lenders continue to use relationship underwriting rather than automated statistical scoring methods in making larger-sized small business loans with collateral, these loans are less likely candidates for securitization. Moreover, even with industry consolidation, underwriting heterogeneity in larger small business loans remains even within a large bank holding company. However, since investment banks and rating agencies "underwrite the underwriters" as well as the loan pool, banking mergers have increased the likelihood of the securitization of small business loans. That is, as banks merge, there are larger pools of loans available for securitization from fewer originators, thereby reducing the number of originators that need to be underwritten to create a loan pool of certain size. The costs of conducting due diligence of a loan pool and the loan originator(s) are much reduced. Therefore, consolidation in the banking sector improves the feasibility of a secondary market for conventional small business loans even in the absence of uniform underwriting standardization among small business lenders.

Scope and Methodology

The authors derived their analysis from two sources: previous studies on the potential for a secondary market for small business loans, small business lending, and the potential impact of credit scoring on small business lending; and the results of interviews with secondary market participants who had direct experience with small business loan securitization. The authors contacted representatives of 20 companies that participate in the conventional small business loan industry and conducted interviews with representatives of eight companies. While the results of these discussions are not scientifically representative of all industry participants, they do provide insights from knowledgeable market observers who participate in small business lending.

Ordering Information

The full text of this report and summaries of other studies performed under contract to the U.S. Small Business Administration's Office of Advocacy are available on the Internet at ***www.sba.gov/advo/research***.

Printed copies are available for purchase from:

National Technical Information Service
5285 Port Royal Road
Springfield, VA 22161
Tel. (800) 553-6847
TDD: (703) 487-4639
www.ntis.gov
Order number: PB2003-103285

To receive email notices of new Advocacy research, press releases, regulatory communications, and publications, including the latest issue of *The Small Business Advocate* newsletter, visit ***http://web.sba.gov/list*** and subscribe to the appropriate Listserv.