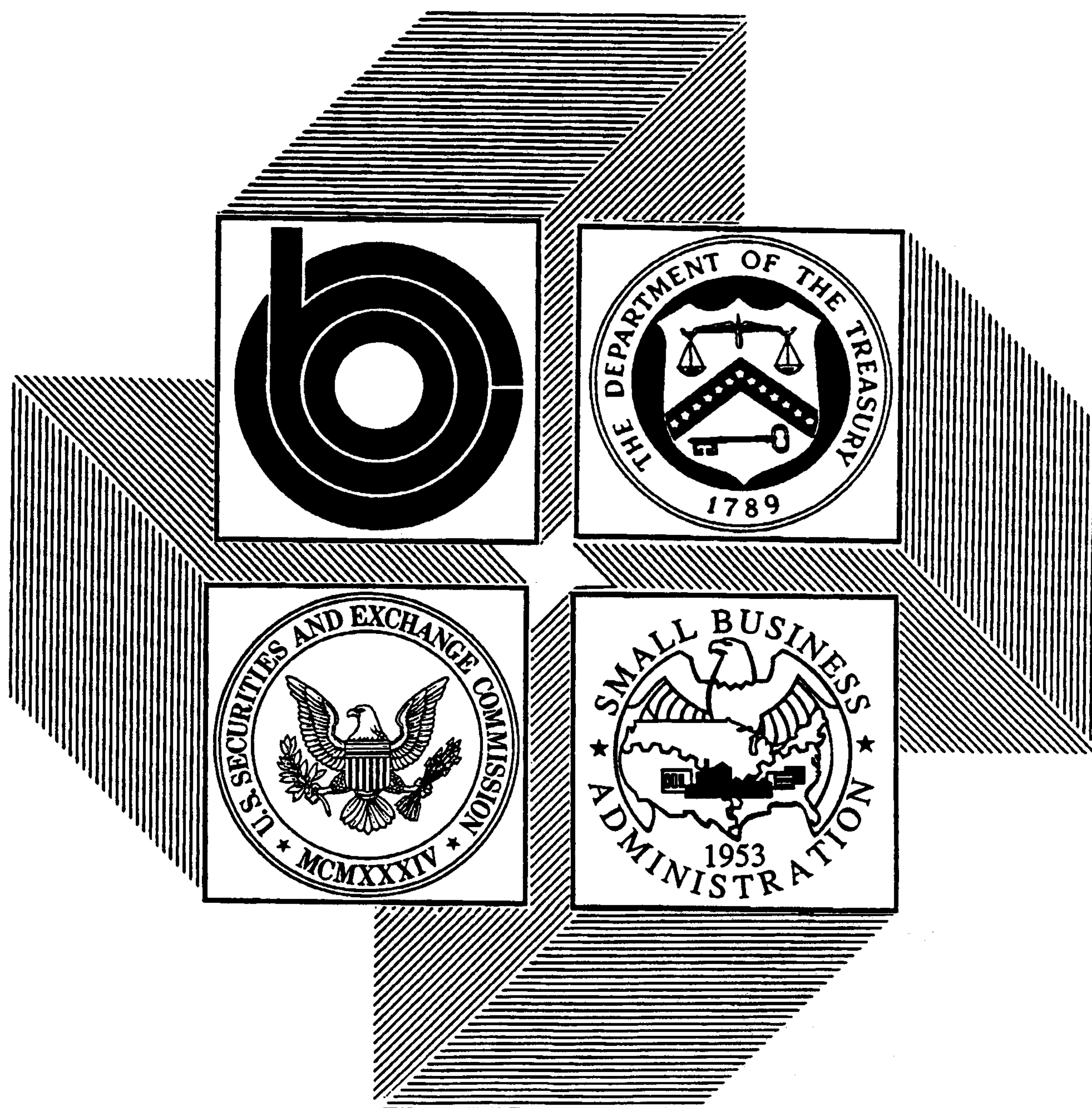
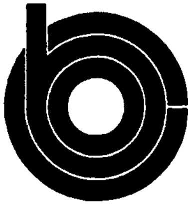
Developing a Secondary Market For Small Business Loans

An Interagency Report
August 1994





Honorable Albert Gore, Jr.
President of the Senate
Washington, D.C. 20510

August 26, 1994

Dear Mr. President:

This report satisfies the requirements of Section 311 of the Small Business Credit and Business Opportunity Enhancement Act of 1992 (P.L. 102-366). That statute directs the Secretary of the Treasury, the Director of the Congressional Budget Office (CBO), and the Chairman of the Securities and Exchange Commission (SEC), in consultation with the Administrator of the Small Business Administration (SBA), to study and report to the Congress on "the potential benefits of, and legal, regulatory, and market-based barriers to, developing a secondary market for loans to small businesses."

Richard S. Carnell, Assistant Secretary for Financial Institutions, Department of the Treasury; Marvin Phaup, Deputy Assistant Director, Special Studies Division, CBO; and Linda C. Quinn, Director, Division of Corporation Finance, and Martin Dunn, Chief Counsel, Division of Corporation Finance, SEC; led each of their agency's work on the study. The working group included Gordon Eastburn, John B. Lewis, and Brian S. Tishuk, Department of the Treasury; David Torregrosa, Kim Kowalewski, Mark Booth, Ron Feldman, Douglas Hamilton, Robert Hartman, Judy Ruud, Elliot Schwartz, and Robin Seiler, CBO; Michael Mitchell, and Darrell Braman, Jr., SEC; and Ed Cleveland, James Hammersley, and Karen Hontz, SBA.

Sincerely,

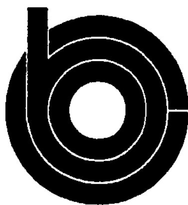
Robert D. Reischauer
Director
Congressional Budget Office

Lloyd Bentsen
Secretary
U.S. Department of Treasury

Arthur Levitt, Jr.
Chairman
U.S. Securities and Exchange Commission

Erskine Bowles
Administrator
U.S. Small Business Administration

IDENTICAL LETTER SENT TO HONORABLE THOMAS S. FOLEY



Honorable Thomas S. Foley
Speaker of the House
U.S. House of Representatives
Washington, D.C. 20515

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SUMMARY

Some members of the Congress have expressed concern over reports of restrictions on the availability of bank credit to businesses that are too small to borrow directly in the commercial paper and bond markets. They fear that worthwhile projects are being denied financing simply because they are undertaken by small firms. Other observers see less cause for concern in the periodic fluctuations of credit flows to small business. In their view, variations in the use of credit by small business mirror changes in the credit quality of borrowers and in business opportunities available to these firms as a result of the business cycle. These observers also note the increasing importance of finance companies and other nontraditional lenders in providing funds to small businesses.

Despite differing assessments of current events, most policymakers appear to agree that a secondary or resale market for loans to small businesses may increase access by small business to loan funds. This agreement reflects the favorable effects that a secondary market for mortgages has had on the availability and cost of housing credit. Before there was a market in which mortgages were bought and sold, financing for home buyers was subject to wide swings in availability. Although these fluctuations were caused largely by interest rate ceilings imposed by Regulation Q, secondary markets now provide a reliable source of credit to borrowers by increasing the liquidity of loans. Efficient secondary markets can also reduce costs to borrowers by increasing liquidity for loans and providing lenders with access to a broader pool of capital. The success of secondary markets in improving mortgage finance suggests that they might provide the same

benefit to small businesses. As the federal government subsidized the development of secondary mortgage markets, some argue that the government might do the same for business loans. At the very least, proponents argue, the government should remove the legal, regulatory, and tax impediments to the development of a secondary market for loans to small business.

U.S. experience with secondary markets for credit card loans, auto loans, and trade receivables shows that these markets can develop without federal support. In order for this to occur, the benefits of selling loans must exceed the costs. Where secondary markets have been slow to develop, the high cost of transactions seems to be a major inhibitor.

For small business loans, significant expense may be incurred in communicating information to potential investors about loans and borrowers. This information is essential in order to allow buyers to evaluate accurately the quality of the loans. For small business loans the terms of each credit contract and the financial circumstances of each borrower are often unique and complex. For example, in many cases the key factor determining the credit quality of a loan to a small business is the managerial ability of the owner or operator. A lender's assessment of this quality is often subjective and difficult to quantify. Persuading a potential small business loan buyer to accept the lender's evaluation can be time-consuming and expensive.

It is significant that "credit enhancement" of business loans can reduce the cost of obtaining and processing information about loan quality. Credit enhancement reduces the risk assumed by the

purchaser and hence reduces the need for this information. Credit enhancement can be provided by third party and seller guarantees or by safeguards built into the securitization process. Securitization is a means of transforming individual loans into pools of loans and then into tradable securities representing claims on the cash flows from the pool. When the cost of credit enhancement is small in relation to the benefits from the sale, any type of loan can be securitized and sold.

The transaction costs of selling small business loans and the importance of credit enhancement in reducing these costs have important implications for federal policy. If government cannot reduce transaction costs, then it can either subsidize the development of this market or wait until improvements in information technology reduce costs to the point at which the market can develop spontaneously. Some analysts have suggested that the Small Business Administration ("SBA") might reduce transaction costs by promoting industry-wide loan documentation and underwriting standards. This would require the government to identify information that would enable investors to distinguish various levels of credit risk. If the subsidy option is considered, it must be weighed against the alternative uses of resources, including the expansion of existing programs to assist small business.

The federal government, at minimal expense, can reduce some costs of selling small business loans and thereby encourage the development of this market. Among these costs are those of complying with state and federal securities laws, banking and pension regulations, and the tax laws. Whether the government should lower these selling costs depends on what must be sacrificed to do so.

Where the effort to reduce costs requires some loss of investor protection, lender safety and soundness, or tax revenues, the government must weigh the desirability of various trade-offs in making these decisions.

In summary, the major findings of the study group include:

- Any current shortage of credit for small business is not caused by a shortage of funds for lending.

- A secondary market could increase access by small business to loan funds.

- Over the longer term, a private secondary market could emerge. Indeed, there are signs this is happening now. This market would facilitate the availability of funds to lending institutions and to small businesses.

- The federal government could aid the formation of this market by removing or modifying those securities, banking, tax, and pension laws that inhibit the market's development. Change should be undertaken carefully, however, to ensure that the benefits exceed the costs in investor protection, lender safety and soundness, and tax revenues. Some regulations are now in the process of being revised.

- SBA could contribute to the development of a private secondary market by increasing the flow of information to potential market participants about the performance and availability for sale of small business loans.

- Today's highly effective secondary market for residential mortgages developed gradually by overcoming obstacles similar to those that currently impede secondary market transactions in small business loans.

- Any secondary market in small business loans is likely to be much smaller than the market for residential mortgages.

- A secondary market would provide benefits to small businesses, lenders, and investors. Some small firms could benefit from lower interest rates and increased credit availability, lenders would benefit from increased liquidity, and investors would benefit from an increased menu of financial assets.

CHAPTER I
INTRODUCTION

Because its supply is limited, credit is never available to all potential borrowers. Furthermore, tightened policy and dampened expectations periodically constrict the total supply of credit. In the competition for credit, small and new businesses are likely to be denied because they have fewer sources of funds and tend to be higher risks than larger, more established enterprises.

Small businesses often need to borrow small sums for short periods. The costs of credit searches and transactions make it impractical for these borrowers to raise relatively small sums from a variety of lenders and investors, causing them to be dependent on a few local lenders for credit. With little capital, they cannot withstand economic adversity for very long.

Restricted availability of credit to small business raises public policy concerns, particularly if it results in an inefficient allocation of capital. If, for example, small businesses are denied credit for investments that have a higher rate of return than those projects that are financed by larger firms, capital is not being used efficiently. Unfortunately, there is no definitive way of knowing whether capital is being allocated efficiently to businesses of varying sizes. No one has demonstrated that small businesses generally could use the proceeds of loans more productively than those who actually receive the funds, although instances where this seems to be the case can be found.

Advocates argue that removing existing legal and regulatory impediments could facilitate the creation of a new institutional link between small businesses and the national money and capital markets without compromising the public policy objectives of those legal and regulatory frameworks. The idea, patterned after experience with the mortgage markets, is that if small business borrowers could gain continuous access to these markets, money would always be available at some price. The device proposed for creating this linkage is a secondary market for small business loans.

What Is A Secondary Market?

A secondary loan market is a resale market, as opposed to a primary market in which loans are originated by lenders and borrowers. Secondary markets for loans consist of transactions between holders of loans--whether acquired by origination or purchase--who wish to sell them and investors who wish to buy them. The sale or purchase of a loan in the secondary market transfers to the buyer the loan's future cash flows, and may include guarantees by the seller or a third party that protect the purchaser against losses from default by the borrower. Following a sale, responsibility for collecting payments when due and otherwise servicing the loan, for a fee, may remain with the originator or be assigned to another.

Secondary market transactions may involve the transfer of whole loans from one financial intermediary--such as a bank, finance company, pension fund, or insurance company--to another. Whole loan transactions, which are usually individually negotiated, redistribute loan holdings among financial institutions but rarely

substantially reduce the cost of converting these loans into cash. Such markets, therefore, do not increase the liquidity of individual loans appreciably.

For a secondary loan market to maximize the increase in liquidity, or the ease with which loans can be sold, whole loans must be broken up into components that can be sold without incurring high transaction costs. This separation of loans into saleable parts is called "securitization" because individual loans are converted into several types of marketable securities, each representing a claim on some portion of the original loans' expected cash flows. Loans are converted into securities by creating a legal entity, a special purpose vehicle ("SPV")--often a trust--to which whole loans are sold. The SPV in turn issues securities that represent either an ownership in it, or a debt obligation. Payments on the securities are financed from the cash flow generated by the pool of assets.

Generally, the most senior interests issued by the SPV represent claims on underlying payment streams that are most likely to be received when due; other, more junior securities represent claims on income of less certain timing; and other securities, which are closer to equity than debt, represent claims on uncertain income. The greater liquidity of these securities in relation to the underlying loans reduces the cost of selling them and is the direct result of risk reduction through diversification and, frequently, credit enhancement.

The Benefits Of Secondary Markets

A secondary market for loans benefits originators, borrowers, and investors, an advantage that motivates such markets and explains their spontaneous development. Principal benefits include lower interest rates, increased availability of credit for borrowers, and greater liquidity and diversity of loan assets for lenders and investors. These advantages are most evident in secondary markets where loans have been "securitized."

A security that represents a claim on a prorated share of the income from a diversified pool of loans is likely to have a more stable income flow than a single loan. This greater stability, without a decrease in expected return, raises the value of the loans. Securitization also enables the risks and returns of loans to be divided into their component parts and tailored to a variety of investor preferences. If this separation enables investors to move closer to their preferred portfolios, the prices of loans in secondary markets will rise and the cost of funds to borrowers will decline further.

Finally, a secondary market may reduce fluctuations in the flow of credit to borrowers who are dependent on a small group of primary lenders. Many small businesses, in fact, are dependent on commercial banks for external financing. When tightened deposit insurance supervision, higher capital requirements, or regional factors reduce the banking system's capacity to lend, the availability of credit to small business firms may also be reduced. A secondary market for small business loans--by increasing access to national and international capital markets--would make these businesses less susceptible to

disturbances in the banking system, even though they would still be affected by changes in financial markets and in their own credit quality. During the last 10 years, when much of the thrift industry encountered severe financial stress, secondary markets were often effective in maintaining the flow of credit to home buyers. Because the secondary market in home mortgages was well established, home buyers were largely unaffected by the economic upheaval among traditional home mortgage lenders. 1/

Why Do Secondary Markets For Loans Develop?

As a rule, secondary markets for loans arise when loan holders anticipate that benefits from a sale exceed the costs of the transaction. Technological developments--especially those in information processing and communications--reduce the costs of transactions and expand the range of loans for which the cost of sales is less than expected benefits. 2/ Thus, secondary markets tend to arise first for those loans that have the lowest transaction costs. Gradually, the range of assets that can be sold in secondary markets expands as improvements in the ability to evaluate information reduces transaction costs. Furthermore, whole loan markets usually precede and then give way to secondary markets with securitization. One explanation for this sequence is that start-up costs are higher for

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1/ Congressional Budget Office, *The Federal Home Loan Banks in the Housing Finance System* (July 1993).

2/ For a thorough discussion of the determinants of securitization, see Allen N. Berger and Gregory F. Udell, "Securitization, Risk, and the Liquidity Problem in Banking," Klausner and White, eds., *Structural Change in Banking* (Homewood, Illinois: Business One Irwin, 1993), pp. 227-291.

securitization, but once these costs are paid, securitization adds more value after costs than whole loan transactions.

Costs inherent in secondary market transactions include those involved in locating a potential buyer, communicating to the buyer a large amount of detailed information about the borrower, and negotiating terms. The securitization approach reduces some of these costs, such as those of finding a buyer, but it increases other costs because it is necessary to create a trust or other special entity in order to purchase the loans and issue securities. These securities, in turn, must be underwritten and distributed to investors. The loan pool still must be serviced and the proceeds distributed according to the terms of the securitization. And, of course, the tax code and the securities laws must be adhered to and investors protected, all of which can add to the costs of securitization. Clearly, for the billions of dollars' worth of credit card and car loans that have already been securitized by banks and other financial institutions, expected benefits exceed the expected costs of secondary market sales. 3/ For the even larger volume of conventional home mortgages that have been securitized during the last 20 years, it is quite likely that expected benefits were greater than expected cost. The reason for any doubt at all is that interest rates on many of these home mortgage transactions were artificially reduced through government-sponsored enterprises such as

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3/ Richard Cantor and Rebecca Demsetz, "Securitization, Loan Sales, and the Credit Slowdown," *Quarterly Review*, Federal Reserve Bank of New York, vol. 18, no. 2 (Summer 1993), pp. 27 - 38.

the Federal National Mortgage Association ("FNMA") and the Federal Home Loan Mortgage Corporation ("FHLMC"). 4/

Another way of describing the development of secondary markets in loans is that such markets develop where loan asset sales provide the lowest cost of funding for primary lenders. 5/ That is, a bank or other financial intermediary can obtain funds by attracting deposits, borrowing, or selling loans. In order for loan sales to be attractive, their funding must cost less per additional dollar of funds than other sources. Declines in the cost of funding from sources other than loan sales can reduce the economic incentive to sell and slow the development of a secondary market.

If costs and benefits drive the development of secondary markets, it may be presumed that the costs of selling small business loans are higher than other types of loans that have been securitized. Chief among the sources of these higher costs is that the information required to project accurately their cash flows is more detailed, specific to the borrower, and more difficult to communicate to potential investors.

Small business loans do not have standard terms. The repayment schedules vary according to type of credit and use of proceeds. In

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4/ Congressional Budget Office, *Controlling the Risks of Government-Sponsored Enterprises* (April 1991).

5/ Stuart I. Greenbaum and Anjan V. Thakor, "Bank Funding Modes: Securitization Versus Deposits," *Journal of Banking and Finance,* vol. 11 (1987), pp. 379-401. The costs of funding through deposits or borrowing must also include an appropriate capital charge, where the assets purchased remain on an entity's balance sheet.

addition, repayment terms are frequently revised to accommodate the borrower's cash flow. The collateral used to secure them may be difficult to appraise, especially where the collateral is not real property. The real security behind the loan is sometimes the character or personal skills of the owner of the enterprise. Very small business and new business borrowers often lack a complete set of audited financial statements.

Evaluating small business credit is not an impossible task, however. Many primary lenders have prospered by lending to small businesses. One practice that enables intermediaries to economize on costly information is the long-term banking relationship. In order to assure themselves of a reliable flow of credit, businesses often repeatedly borrow from the same lender or small group of lenders while purchasing other (checking, accounting, short-term investment) services from them. Frequent and enduring contact with the borrower permits the lender to monitor the creditworthiness of these borrowers at relatively low cost. 6/

Primary lenders who specialize in evaluating loan proposals can distinguish better credit risks from poor ones. But the same information that permits lenders to do this gives them an advantage over the nonspecialist investor or the insurer of a loan pool. In general, the purchaser cannot know as much about the loan and the borrower as does the originating lender. Given this so-called asymmetric distribution of information, a rational purchaser may

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6/ Michael Klausner and Lawrence J. White, "Bank Regulatory Reform and Bank Structure," *Structural Change in Banking* (Homewood, Illinois: Business One Irwin, 1993), pp. 1 - 17.

assume that the originator would offer poor quality loans for sale while representing them as first quality. The buyer would therefore offer a price appropriate only for the poorest quality loans. Under these circumstances, markets tend not to develop.

There are a number of elements present in secondary markets which may remedy this informational mismatch. These remedies include: (1) sellers must protect their reputations by accurately representing loan quality, should they wish to sell additional loans in the future; (2) the seller may retain liability for loss, which nullifies incentives that the originator might have to sell poor quality loans; 7/ (3) the application of the federal securities laws disclosure and liabilities provisions to transactions in these markets; and (4) the use of credit enhancement. 8/

7/ It should be noted that under current federal regulations, if any risk is retained by an insured commercial bank, the bank's capital requirements are not reduced by the sale. When a bank has no excess of capital it will not be able to sell existing loans to finance additional lending. The regulations specifying bank capital requirements currently are being revised. For a more complete discussion of bank capital requirements, see Chapter III.

8/ See Appendix D.

Role of Government in Developing Secondary Markets For Loans

Although a secondary market in business loans is beginning to emerge, 9/ the government may still play a role in its development. 10/ Alternative roles fall into two general categories: (1) reducing the costs of secondary market transactions; and (2) providing subsidies to the market.

Reducing Costs

Efforts at reducing the costs of loan sales have consisted largely of lightening the regulatory expense of such transactions. The most significant of these changes has been the adoption by the Securities and Exchange Commission ("SEC") of Rule 3a-7 in November 1992. This rule exempted securitizations of loans from the provisions of the Investment Company Act of 1940 (the "Investment Company Act"). Several portfolios of small business loans have been converted into securities since the SEC's move, including loans held by The Money Store 11/ and Fremont Financial Corporation ("Fremont"). In both cases, the SEC rule change was cited as an important factor in making the transaction feasible.

9/ See Appendices A and C, respectively, for a discussion of the secondary market for SBA guaranteed loans and a description of those small business loan securitizations that have been completed.

10/ Arnoud W.A. Boot and Stuart I. Greenbaum, "Contemporary Developments in Banking," *Working Paper 192*, (Banking Research Center, Kellogg Graduate School of Management, Northwestern University, June, 14, 1993).

11/ Citations in this report to "The Money Store" reference two affiliated SBA loan originators more fully described in Appendix C.

Another regulatory change that is currently under discussion could have significant implications for bank loan sales. It is a proposal to modify the capital standards for loans sold with guarantees or some other form of seller assurance. This proposal would reduce the capital requirements on loan sales with recourse to an amount equal to the expected loss to the bank for certain low-level recourse transactions.

A third approach to reducing the cost of secondary market transactions would involve the SBA. Under this plan, the SBA would make available its historical records on the loan repayment experience of SBA-guaranteed loans. These data could be useful in reducing uncertainty about the financial performance of small business loans under a variety of economic circumstances. It has also been suggested that the SBA could assist in developing a computerized loan market that would link lenders with loan poolers for both SBA and non-SBA loans.

Providing Subsidies

Alternatively, the federal government might subsidize the development of a secondary market in small business loans. Private entities could be subsidized to help them bear the start-up costs of a secondary market with securitization. Or the government could bear the cost of these subsidies through a federally owned entity or a privately owned, government-sponsored enterprise. All of these options shift some of the costs of securitization to taxpayers.

Some of these options have the advantage of limiting and explicitly recognizing the cost to the U.S. Treasury in advance. For example, if the government were to pay private contractors to establish and maintain secondary markets or write pool insurance for designated loans, costs would be limited and recognized up front, when the government made the payment. 12/

The Congress could also authorize a federal agency such as the SBA to create these markets. Administrative costs of these activities would appear in the federal budget along with the estimated cost of subsidizing any guarantees or financial insurance.

An alternative approach would create a government-sponsored, but privately owned, enterprise to carry out these activities. Controlling costs in this case would be difficult in comparison with direct federal budget provision because the federal government's subsidy--from the implied guarantee of a government-sponsored enterprise's debt--would be unrecognized and not directly controlled through the budget process.

Virtually all of these subsidy-providing options could be costly to the federal government if not enough attention is paid to the inherent

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12/ SBA's employment of a private fiscal and transfer agent for all loans guaranteed under its 7(a) program and sold in the secondary market provides a precedent for the use of private firms to organize and operate secondary markets. In the SBA market, the agent creates records of sale for each transaction, including the creation of loan pools, and processes and forwards borrower payments to investors. The fiscal and transfer agent is paid through fees for the transactions and does not use taxpayer funds.

difficulty of valuing small business loans. 13/ The principal requirement for a federal policy that accelerates the development of a secondary market, increases the efficiency of investment, and does not impose large losses on taxpayers, is that it should successfully identify and address those factors that have retarded the growth of this market to date.

13/ Mark Jickling, *Secondary Market for Small Business Loans* (CRS Report for Congress, 93-758 E, August 23, 1993).

CHAPTER II

TRENDS AND FLUCTUATIONS IN THE FLOW OF CREDIT TO SMALL BUSINESS

The "credit crunch" of the early 1990s triggered a flurry of claims of credit rationing to small businesses. This episode renewed interest in creating a secondary market for small business loans. Analysts have noted that business lending by commercial banks was particularly weak during this period, and some believed that it was caused by a sharp reduction in the supply of loans and the tightening of loan terms by banks. Because small businesses rely heavily on banks for credit, there was concern that the crunch especially hurt them. Partly because they feel that small business is the major source of job growth, some analysts viewed the squeeze as a major cause of the recession between July 1990 and March 1991 and the unusually slow economic recovery.

Consequently, policymakers became very interested in finding ways to increase the flow of credit to small businesses. One attractive solution was encouraging the development of secondary markets for small business loans. Policymakers understood the success of secondary markets in increasing the liquidity of home mortgage loans and lowering borrowing rates of interest in that market. They expressed an interest in knowing whether an active secondary market could be similarly successful in the market for small business loans.

But if the desire to ameliorate any recent credit tightening were the only motivation for encouraging the development of a secondary

market, there would be less reason for policymakers to act now, as banks are much more able to lend than they were in the 1990-1991 period. Moreover, many analysts believe that a drop in the demand for bank credit explains most of the decline in bank lending, and that factors other than a credit crunch, such as the lack of fiscal stimulus and the wave of corporate restructuring, also played a role in the unusually sluggish recovery from the 1990-1991 recession.

Apart from the desire to counteract the "credit crunch," policymakers may also wish to encourage a secondary market in order to reduce the chances of future credit crunches for small businesses and, in general, to provide another financing mechanism. Here again, the need for strong government action is not entirely clear, as businesses have increasingly relied on non-bank sources of funds. 14/

Recent Developments in the Market for Bank Loans to Small Business

Proponents of a secondary market for small business loans argue that the reduction in borrowing by small businesses during the early 1990s was largely caused by a reduction in the supply of bank loans. They argue that large losses on commercial real estate loans, higher capital requirements, and stricter regulation forced banks to tighten their lending standards and cut back lending to small businesses. Because they had little access to other sources of credit, small businesses could

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14/ It should be noted that those loan originators which have securitized small business loans have been non-bank financial institutions which may not rely upon deposits as a source of funds. For a complete discussion of these securitizations, see Appendix C.

not expand their operations, which in turn hurt overall economic activity.

But other economic factors contributed to the slowdown in lending. At the same time banks were cutting back their loans, the economy was tipping into recession, and businesses were reducing their demand for credit. It is uncertain whether the supply of bank loans fell further than warranted by weak economic activity and left creditworthy borrowers without a source of funds. The only certainty is that bank lending decreased.

In any event, recent developments indicate improved conditions in the market for bank loans to small businesses. Several factors behind the apparent drop in the supply of bank loans have abated, and the demand for loans is picking up. As a result, nonmortgage borrowing from banks by the noncorporate business sector--a crude proxy for small business borrowing--has strengthened over the past year.

Improvements in the Supply of Bank Loans

One important indicator of improvement in the potential supply of bank loans to small businesses is the strong profitability and improvement in asset quality at commercial banks in the past year and a half. These improvements, together with modest growth in economic activity, have made banks more willing to make new loans, according to recent surveys of bankers. 15/ In addition, the

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15/ The Board of Governors of the Federal Reserve System agrees that the recent reduction in bank lending was mainly the result of "weak demand." See Board of Governors, "Monetary Policy Report to the Congress,"

Administration has adopted regulatory and administrative changes aimed at increasing the availability of bank loans to small businesses.

Stronger Bank Profitability

According to the Federal Deposit Insurance Corporation ("FDIC"), insured commercial banks earned a record setting net income of $43.4 billion in 1993. This figure was more than one-third higher than the previous record of $32.0 billion set in 1992. The average return on assets ("ROA") for 1993 was 1.21 percent, marking the first time since the creation of the FDIC that full-year ROA has exceeded one percent. Banks in all regions and all size groups reported ROAs exceeding one percent. Over 95 percent of all commercial banks reported positive net income for 1993, the highest proportion since 1980.

During 1993, the banking industry benefitted in particular from continued cost-cutting, a wide margin between the yields on assets and the cost of funds, and an improvement in asset quality. The net interest margin continued at high levels and ended 1993 at 4.4 percent of average net consolidated assets, compared with 4.5 percent in 1992. Thus, banks have maintained their profitability despite rising interest rates. Troubled assets (non-current loans and foreclosed

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Federal Reserve Bulletin (March 1993); statement of John P. LaWare before the Subcommittee on Economic Growth and Credit Formation of the House Committee on Banking, Finance, and Urban Affairs, April 2, 1993, reprinted in *Federal Reserve Bulletin* (June 1993). See also William Jackson and Gail Makinen, "A Credit Crunch? Bank Lending and National Credit Patterns 1989-1992," *CRS Report for the Congress* 93-518 E (May 20, 1993).

property), as of the end of 1993, were at their lowest level since the end of 1986. These dramatic improvements in commercial bank asset quality offer the hope that commercial real estate values and related losses at commercial banks have bottomed out.

Some analysts are concerned that bank profits will erode if short-term interest rates continue to rise. Such a rise, they fear, would reduce banks' net interest margin. But higher short-term interest rates will coincide with a stronger economic expansion and greater loan demand. Banks may be able to maintain their net interest margins by buying fewer securities and making more, higher-yielding loans to offset some of the added cost of funds.

Greater Willingness to Make New Loans

Informal surveys of bank loan officers by the Federal Reserve indicate that since the spring of 1993, banks have been increasingly willing to make commercial and industrial loans (other than for mergers) to businesses of all sizes. The Senior Loan Officer Opinion Survey on Bank Lending Practices, which polls about 60 domestic commercial banks and about 18 U.S. branches and agencies of foreign banks around the country, noted that the easing of lending terms and standards reported in May 1993 (the "May 1993 Survey") had continued in the August 1993 Survey. Standards for commercial real estate loans were little changed in the August 1993 Survey, however, and remained very restrictive.

The August 1993 Survey also found that capital positions were less important constraints on bank lending. Almost all respondents judged

their banks' capital positions to be fairly or very comfortable. The proportion of respondents who eased their lending terms and standards because of comfortable capital positions rose from one-fifth in the May 1993 Survey to more than one-third in the August 1993 Survey. Strong profitability, combined with record issues of new capital, boosted equity capital of banks by almost 14 percent in 1992. The industry's ratio of capital to assets rose by about one-half of a percentage point to just over 7 percent.

Even between 1990 and 1992, most respondents reported that a poor economic outlook was the main reason they tightened loan terms and standards. As in the May 1993 Survey, most of those who eased their lending terms and standards reported difficulty finding attractive lending opportunities.

The Administration's Credit Availability Program

In response to concerns about the availability of credit, the Administration has adopted a number of regulatory and administrative changes aimed at increasing the availability of credit, particularly to small and medium-sized businesses, farmers, and borrowers living in low-income communities.

In order to spur lending to small businesses, the bank regulatory agencies issued a policy statement that will allow strong banks and thrifts to make and carry loans to small and medium-sized businesses and farmers with only minimal loan documentation. This action is designed to allow bankers to make so-called character loans. To improve the climate for real estate lending, the agencies have

proposed a rule that would reduce the burden of real estate appraisals and related paperwork. Another rule would help banks move the real estate they own off their balance sheets and into the hands of investors willing to improve the property. These initiatives have been supported by such independent observers as the General Accounting Office. 16/

In addition, the bank regulatory agencies have tried to improve the relationship between examiners and bankers. As part of this effort, the agencies have developed an improved process designed to increase the effectiveness of appeals of examiner decisions.

According to the August 1993 Survey, the new agency program had little immediate impact on lending. Nevertheless, respondents to the survey expect that when fully put into effect, the program will help to ease terms and standards for loans to small and medium-sized businesses.

Strengthening Demand for Bank Loans by Business

Many analysts believe that most of the decline in bank lending during the early 1990s was not caused by a drop in the supply of bank loans, but by a drop in the demand. Several factors lie behind such a drop, including:

- The heavy debt burdens that businesses and consumers carried into the last recession;

16/ See *Bank Regulation: Regulatory Impediments to Small Business Lending Should Be Removed*, GGD-93-121.

- o Reduced investment in inventory and fixed capital by businesses in the face of weak economic activity; and

- o A switch from short-term to long-term debt by business in response to the drop in long-term interest rates.

Recently, there were signs that the demand for bank loans by business is rising. The number of loan officers reporting increases in the demand for bank loans by small and medium-sized businesses rose in both the May 1993 Survey and the August 1993 Survey. Indeed, the nonfarm, noncorporate business sector increased its nonmortgage bank loans by $6.2 billion in the second quarter of 1993, according to Flow of Funds accounts published by the Federal Reserve. It was the first net increase in nonmortgage bank loans held by this sector since the third quarter of 1990 and follows a trend of stronger borrowing from banks by this group over the previous year or more.

The Growth of Nonbank Sources of Credit for Small Business

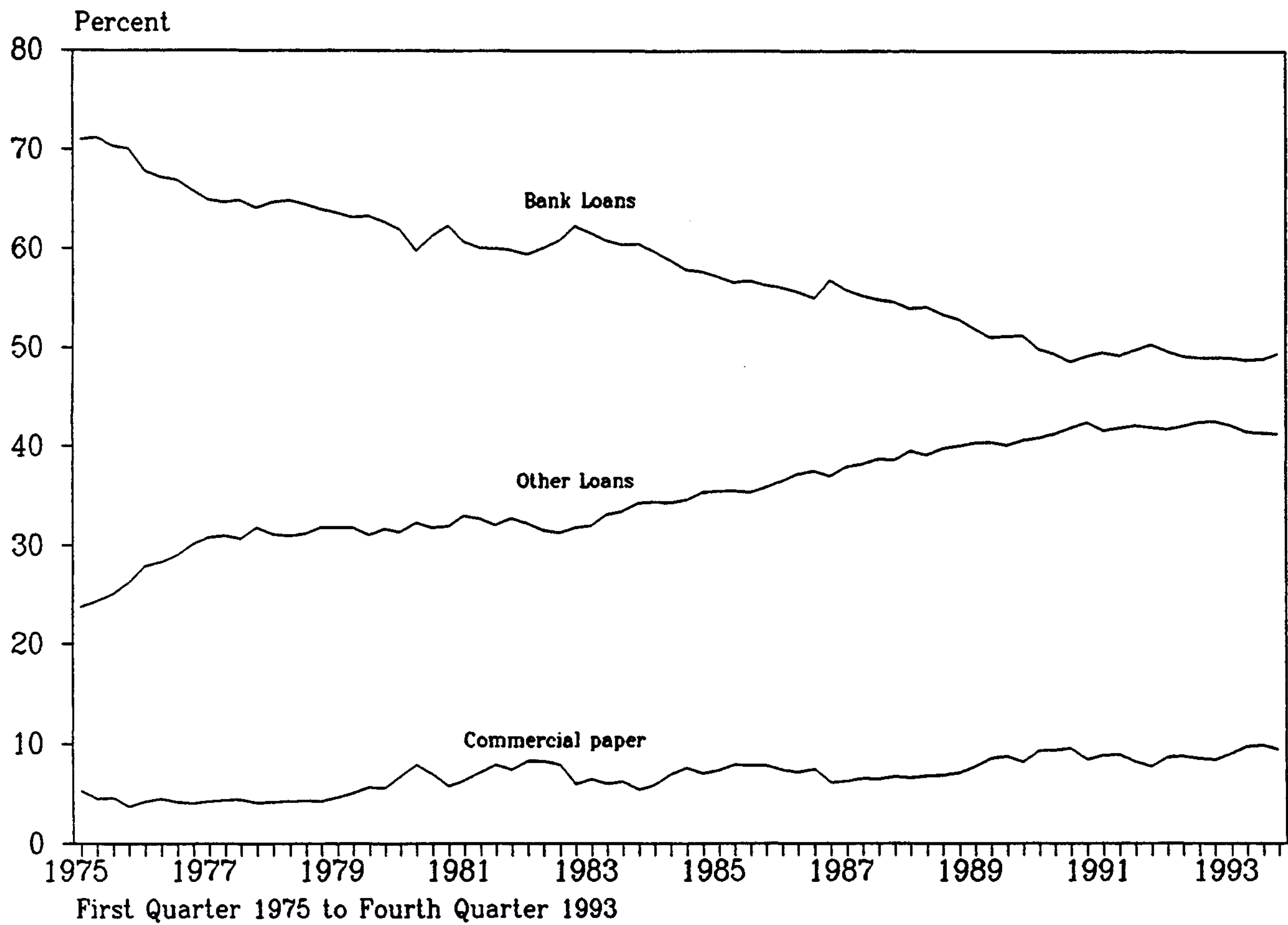
Although recent developments suggest that the supply of bank loans for small businesses has increased, policymakers may still feel that it is necessary to create a secondary market for small business loans in order to dampen the adverse impacts of any possible future credit crunches on small businesses. Even so, it is not clear the government must take strong action. The private credit market has moved to improve the flow of credit to small businesses. Nonbank sources of credit to small businesses have become more important, and a secondary market is beginning to appear.

Reliable data on changes in borrowing over time in the nonbank sector by size of borrower, or even by size of loan, are not available. However, short-term borrowing in the credit markets by the entire business sector indicates the growing importance of private, nonbank sources of credit (See Figure 2-1). Short-term business credit includes bank loans, excluding mortgage loans and consumer credit; other nonmortgage loans; and commercial paper. 17/ In the mid-1970s, commercial banks accounted for about 71 percent of short-term business credit. By the end of the 1980s, however, banks' share had fallen to about 51 percent. At the same time, the share of borrowing in the commercial paper market had risen from about 5 percent to about 8 percent and the share of other nonbank lenders had risen from about 24 percent to about 41 percent. Among these other nonbank lenders, finance companies doubled their share of nonmortgage loans to the business sector over this period. 18/ In addition, foreign lenders became an important source of nonmortgage business loans for nonfinancial corporate borrowers in the 1980s. From negligible amounts in the late 1970s, the share held by foreign lenders rose to about 10 percent at the end of 1989.

17/ This measure probably understates the amount of short term business credit because some mortgage and consumer loans are really business loans. Small businesses pledge real estate as collateral for loans, and may use consumer credit for business purposes.

18/ For a recent discussion of how the inroads made by nontraditional lenders are expected to affect bank loans to small business, see "Loan Demand Will Remain Sluggish Even if Economy Improves, Surveys Say," *Wall Street Journal*, October 20, 1993, p. A4. See also, Cynthia A. Glassman, *The Weakening Role of Banks in Financing Small Business: A Study Prepared for the Banking Research Fund of the Association of Reserve City Bankers,* June 1993.

FIGURE 2-1 COMPONENTS OF SHORT-TERM BUSINESS DEBT

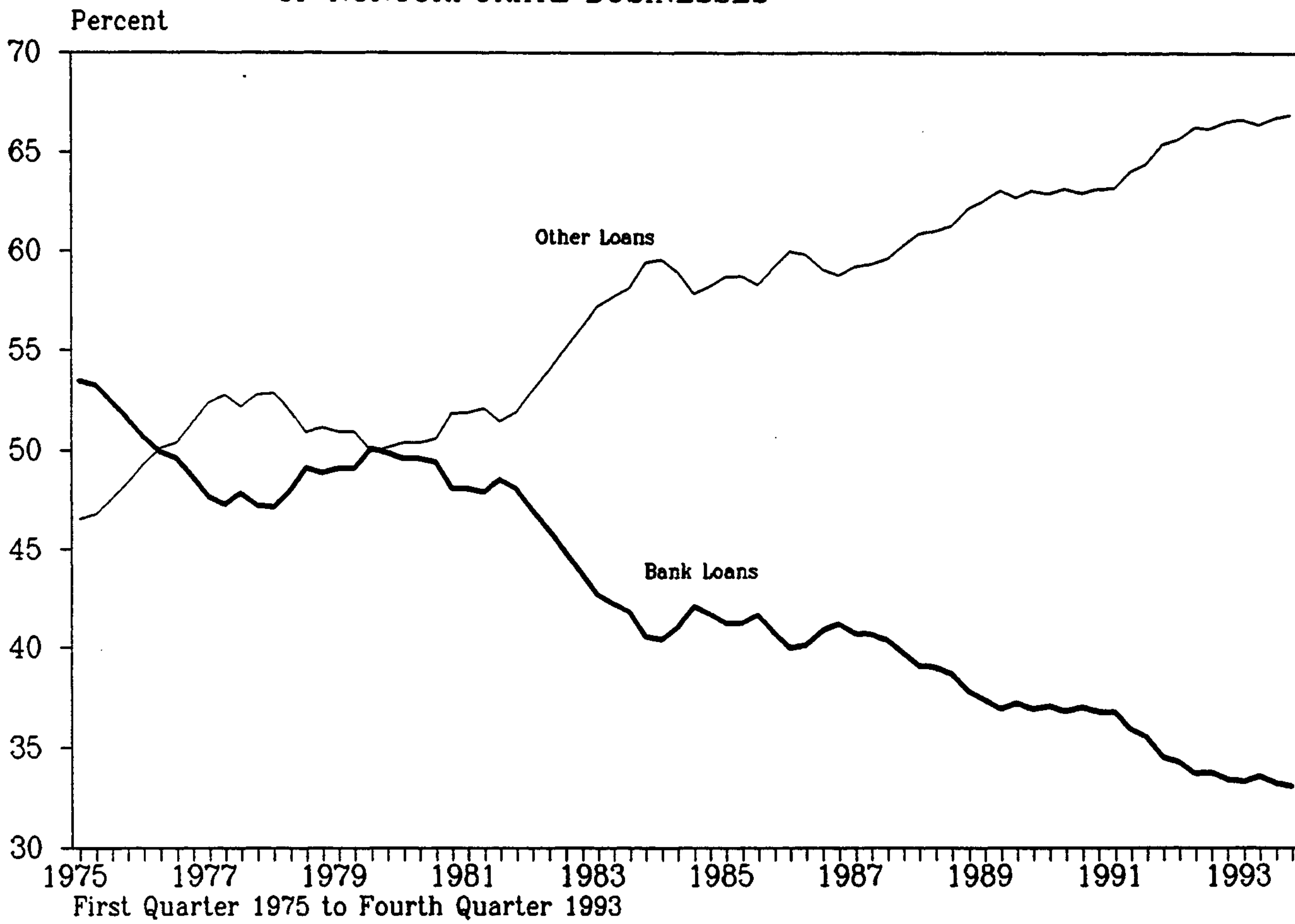


SOURCE: Board of Governors of the Federal Reserve System

Further information on changes over time in the composition of short-term borrowing from nonbank sources by size of business is only sketchy, but tends to confirm the decline in the importance of bank lending observed for the business sector as a whole. Financial data are only available for a subset of small businesses--the noncorporate business sector, which includes partnerships, sole proprietorships, tax-exempt cooperatives, and individuals who rent nonresidential structures. These data, compiled by the Federal Reserve, assume that a constant 50 percent of business loans held by savings institutions, finance companies, and asset-backed issuers go to the noncorporate sector. Consequently, the trend in the share of nonbank lending to noncorporate borrowers should be reasonably indicative even if the level is not. For noncorporate businesses, the share of bank loans in short-term debt has fallen over time, while that of finance companies has risen (see Figure 2-2).

These non-bank sources of credit, which have become increasingly important to small businesses, must obtain funding in the money and capital markets. A secondary market in business loans would provide these non-bank lenders with an additional means of tapping these markets.

FIGURE 2-2 TRENDS IN COMPOSITION OF SHORT-TERM DEBT OF NONCORPORATE BUSINESSES



SOURCE: Board of Governors of the Federal Reserve System

CHAPTER III

FACTORS AFFECTING THE DEVELOPMENT OF SECONDARY MARKETS FOR LOANS

Secondary markets develop when the benefits of loan sales are greater than costs. One of the major cost barriers to the development of such markets is the expense that potential buyers face in attempting to project future cash flows from the loans. Where secondary markets have arisen, the process has been aided by financial innovations that enable investors to assess accurately and easily the prospective returns from securities backed by a pool of loans. These innovations have included the development of securitization, the use of credit enhancements, and the collection, dissemination, and analysis of information about the performance of loans under a variety of economic conditions. Recently, modifications in securities regulations have also reduced costs and stimulated loan sales and securitization. 19/

This experience has implications for federal policy toward secondary markets in small business loans; the high cost of evaluating small business loans must be overcome if an efficient secondary market is to develop. Policies that would increase the predictability of loan cash flow would hasten the market's development. Policies to reduce regulatory costs or standardize small business lending might also be useful. Policies that would have the federal government assume the risk caused by the unpredictability of small business loans could increase the flow of credit to small business and create the

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19/ For a discussion of recent modifications to securities regulations, see Appendix E.

appearance of a robust secondary market, but at some cost to taxpayers and the economy.

Development of Securitization

The modern structured finance market began in the early 1970s. The first financings were of residential mortgages and were a direct outgrowth of federally sponsored programs to assist the housing industry and homebuyers. A principal mandate of the Government National Mortgage Association ("GNMA"), FNMA, and FHLMC was and continues to be to provide greater access to capital for residential mortgage financing through the development of a secondary market for residential mortgages. 20/

20/ GNMA, a governmental agency, guarantees timely (scheduled) payment of interest and principal on a portfolio of residential mortgages. FNMA and FHLMC promote the secondary mortgage market in part by purchasing mortgages and either holding the mortgages or selling them, in the latter case primarily by repackaging the mortgages into securities.

The Congress reshaped FNMA in 1968 and directed it to purchase FHA and VA guaranteed mortgages. In 1971, FNMA was authorized to sell mortgage-backed securities, as well as its own securities, to investors. Also in 1971, the FHLMC was chartered to buy conventional (those not guaranteed by the federal government) mortgages and sell either debt securities or guaranteed claims on the income from pools of mortgages. At the same time, FNMA was given authority to buy and securitize conventional mortgages. These government-sponsored enterprises are privately owned but their obligations carry an implied federal guarantee. For a history and discussion of the risks to the government from guarantees by government sponsored enterprises, see Congressional Budget Office, *Controlling the Risks of Government Sponsored Enterprises* (April 1991).

The first security that was publicly traded and backed by a pool of federally guaranteed mortgages was assembled by a private firm, and guaranteed by GNMA. It was issued in 1970. 21/ Both FNMA and FHLMC subsequently issued mortgage backed securities and, together with GNMA, embarked on mortgage backed securities programs ("agency programs"). 22/

Throughout the 1970s and into the 1980s, agency programs dominated the secondary market for residential mortgages. In an effort to expand the participation of the private sector, the Congress passed the Secondary Mortgage Market Enhancement Act of 1984 (SMMEA). SMMEA attempted to increase the demand for, and market value of, privately sponsored mortgage-backed securities by preempting certain state investment laws. The aim was to allow depository institutions and institutional investors, especially pension funds, to purchase privately sponsored mortgage-backed securities as

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21/ United States Securities and Exchange Commission, Division of Investment Management, "The Treatment of Structured Finance Under the Investment Company Act," *Protecting Investors: A Half Century of Investment Company Regulation* (May 1992), p.6.

22/ The "agency programs" had three significant effects upon the secondary market. First, through GNMA and the implied guarantees of FNMA and FHLMC securities, the government significantly reduced investors' high cost of information about the borrowers and about the credit experience of the mortgage pools by directly or implicitly guaranteeing the pool securities as to credit risk and timely payments. Second, the experience of these agencies provided insurers and investors with substantial historical information on the financial performance of these home mortgages under a variety of economic conditions. Third, GNMA, FNMA, and FHLMC imposed national underwriting and loan documentation guidelines upon the loan originators, facilitating homogeneity and potentially further reducing the cost of predicting the cash flows from these loans.

if they were issued by a federal agency or government sponsored enterprise ("GSE"). SMMEA also attempted to reduce the cost of issuing privately sponsored mortgage-backed securities by requiring states--subject to a state legislative override--to regulate such securities no more stringently than those of federal agencies. Although the contribution of SMMEA is not entirely clear, the volume of privately-issued, mortgage-backed securities has grown rapidly since 1984.

Initial sales of mortgage-backed securities guaranteed by GNMA, FNMA, and FHLMC demonstrated the feasibility of converting loans into liquid securities and led to a proliferation of new types of mortgage-backed securities. More recently, securities have been backed by such real estate financial instruments as loans secured by vacation timeshares, variable-rate mortgages, and manufactured housing loans.

The techniques pioneered in the secondary residential mortgage market served as a foundation for the private sector to securitize other assets. With the development of an established mortgage-backed securities market, market participants recognized that other financial assets generating cash in predictable patterns could also be securitized. Since the mid-1980s, a host of non-mortgage financial assets have been securitized. In early 1985, the first non-mortgage assets to be securitized were computer leases and automobile loans; this was followed, in 1987, with securitization of credit card receivables. In the years since, securities backed by automobile loans and credit card receivables have grown rapidly and now make up more than 80% of non-mortgage asset-backed securities. (See Tables III-1 and III-2).

Table III-1. Value of Mortgage and Asset-Backed Securities Offerings: 1980 - 1992 (In billions of dollars)

		Collateral						
Year	All Issues	Residential Mortgages	Commercial Mortgages	Car Loans	Equipment Loans and Leases	Consumer Loans	Home Equity Loans	Recreational Vehicles
1980	0.5	0.5	0.0	0.0	0.0	0.0	0.0	0.0
1981	0.5	0.5	0.0	0.0	0.0	0.0	0.0	0.0
1982	1.1	1.1	0.0	0.0	0.0	0.0	0.0	0.0
1983	8.6	8.6	0.0	0.0	0.0	0.0	0.0	0.0
1984	12.1	12.1	0.0	0.0	0.0	0.0	0.0	0.0
1985	20.8	19.6	0.0	1.0	0.2	0.0	0.0	0.0
1986	67.8	57.8	0.0	9.8	0.2	0.0	0.0	0.0
1987	91.6	82.7	0.0	6.3	0.0	2.4	0.0	0.0
1988	112.7	98.9	0.3	5.8	0.1	7.4	0.0	0.7
1989	135.4	112.2	0.9	7.9	0.0	11.0	2.7	0.7
1990	176.1	135.0	0.1	12.4	0.0	21.9	6.0	0.6
1991	300.3	251.5	0.0	16.9	0.4	20.7	10.3	0.4
1992	428.2	375.9	3.9	23.2	2.3	15.9	6.3	0.3

SOURCE: Securities Data Company.

Table III-2. Number of Mortgage and Asset-Backed Securities Offerings: 1980 - 1992

Year	All Issues	Collateral: Residential Mortgages	Commercial Mortgages	Car Loans	Equipment Loans and Leases	Consumer Loans	Home Equity Loans	Recreational Vehicles
1980	8	8	0	0	0	0	0	0
1981	12	12	0	0	0	0	0	0
1982	36	36	0	0	0	0	0	0
1983	66	66	0	0	0	0	0	0
1984	117	117	0	0	0	0	0	0
1985	219	212	0	6	1	0	0	0
1986	391	372	0	17	1	0	0	0
1987	500	472	0	21	0	7	0	0
1988	679	625	3	27	1	18	0	4
1989	532	471	4	19	0	25	8	4
1990	577	485	1	22	0	46	17	6
1991	865	748	0	33	2	47	32	3
1992	1138	1011	10	41	7	36	30	2

SOURCE: Securities Data Company.

In more recent years, many other financial assets have come to market, including: home equity loans, commercial mortgages, hospital accounts receivables, wholesale automobile receivables ("floorplan financings"), recreational vehicles and boat loans, computer leases, airplane leases, small business loans, and industrial development bonds backed by a range of assets including equipment leases. 23/

The development of financings supported by a pool of heterogenous assets suggests that the ability to predict cash flows is more important for securitization than the nature of the underlying assets. It seems likely that many more types of financial obligations can be transformed into marketable securities, provided investors or insurers can easily project the cash flows from those financial assets. 24/

Credit Enhancement

Every loan has unique characteristics that affect its credit quality and value. To evaluate loans for purchase, therefore, potential investors must obtain, process and assess large volumes of information about these loan attributes. Doing so is costly. These costs constitute a significant obstacle to the sales of small business loans.

23/ Since the SEC adopted Rule 3a-7 under the Investment Company Act, which greatly reduced the regulatory barriers to asset securitization, there has been continued innovation in the securitization of a broader universe of financial assets.

24/ Richard Rosenberg and Jason Kravitt, "How Feasible is the Securitization of Loans to Small and Medium-Sized Businesses?" *Commercial Lending Review*, Fall 1993, pp.4 et seq.

Some means of reducing transaction costs is required if secondary markets in small business loans are to develop and thrive. The predominant approach in asset-backed securitization is through "credit enhancement," a payment support feature covering defaults and losses on the loans up to a specific amount, thereby reducing investor need for costly loan-specific information. These payment support features can be provided by loan originators who already possess the information necessary to evaluate the loans. For example, the originator may hold the subordinated, or first loss, position in a securitization. One shortcoming of credit enhancement provided by originators is that lending to business is more often constrained by the availability of lender equity capital than by a shortage of loanable funds. Retention of credit risk through the provision of credit enhancement to investors does not reduce the capital needed by the lender and, therefore, does nothing to relieve the lending constraint. It does, however, result in saving on the cost of external credit support.

Alternatively, credit enhancement of small business loans can be provided by third parties (e.g., financial guaranty insurers or letter of credit providers) who are financially strong and specialized in loan evaluation. Financial strength is necessary to make the support obligation credible. Specialized skills minimize the costs of the loan evaluations and the price of the insurance.

A similar, but lesser, information hurdle slowed the development of a secondary market in single family mortgages. There the information obstacle was less onerous because an established track

record for these loans had permitted the development of economically-sound loan insurance. Thus the cost to GNMA, FNMA, FHLMC, and others of providing additional credit enhancement on pools of guaranteed loans was small compared with those costs for small business loans.

Credit enhancement has potential for overcoming the high information costs of small business loan sales that may otherwise inhibit transactions. Yet, because capital requirements are binding for many business lenders and because information costs remain high even for specialized third party insurers, it is unclear that credit enhancement can be delivered with current technology at sufficiently low price to make high volume small business loan securitization feasible. A government agency might offer credit support at a low, subsidized price, but unless the agency also has the capacity to accurately assess loan quality, those guarantees are likely to prove costly to the government. 25/

Capital Requirements and Bank Participation in Loan Markets

Bank capital requirements are frequently cited as an obstacle to bank participation in a secondary market for business loans. (Of course, capital requirements can also raise the cost of, and reduce bank participation in, primary lending or loan origination.) Under current bank capital requirements, federally insured financial institutions that sell loans must hold capital--if they retain any liability for credit losses on the loans--equal to the amount required before the sale.

25/ For a more complete discussion of credit enhancements, see Appendix B.

This requirement is intended to assure that bank lending and guarantees are supported by adequate levels of capital. Without appropriate capital support, the safety and soundness of the banking system would be threatened and the federal government would be exposed to the risk of loss from the failure of federally insured institutions.

If the capital requirements for asset sales are not changed, banks are likely to rely increasingly on alternative forms of credit enhancement that do not require the seller to be liable for any credit losses. If these alternatives are more costly to banks than to their competitors, banks will probably lose market share to lenders outside the banking industry. Such a shift in the flow of credit through financial intermediaries would accelerate the decline in the financial importance of banks.

In fact, the federal banking agencies are in the process of revising the amount of capital that banks are required to hold when they sell a loan and retain partial liability for credit loss. Revised capital standards that ease the requirements for loan sales but retain the current standards for loans held in portfolio, would encourage banks to increase their lending and sell those loans to others. This would give commercial banks the opportunity to act more like mortgage banks; that is, originators but not holders of loans.

Declining Importance of Asset Homogeneity

In the past, asset-backed securities have used pools of homogeneous loans, with similar loan terms and borrower characteristics. The use of similar assets to form pools has been useful in limiting transaction costs because it aids in the analysis of the pool's credit risk. In the securitization of commercial mortgages, for example, rating agencies typically analyze credit risk in an asset pool in one of two ways: by analyzing the characteristics of the pool or by analyzing each loan separately. The methodology applied "will generally depend upon the uniformity of the originator's loan underwriting, the extent to which the pool is representative of the originator's overall portfolio, and the distribution of loan balances." 26/ If the underwriting criteria are uniform, the number of loans is large enough to draw statistical inferences, and loan balances are relatively equal, the rating agency will analyze pool characteristics. A separate loan-by-loan analysis is necessary when some or all of these factors are not present.

More recently, however, a growing number of pools have consisted of more diverse financial assets. Pool assets now sometimes differ in underwriting and collection standards, documentation, and loan balances. Recent registrations received at the SEC include offerings of securities backed by various types of loans, such as corporate debt issued by firms in different industries; commercial leases of different types of properties; residential mortgages originated

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26/ Standard & Poor's Credit Review, *Commercial Mortgage Securities* (April 8, 1991).

in foreign countries; personal, unsecured lines of credit; commercial mortgages; and small business loans. 27/

Homogenous assets are useful in securitization because they reduce the costs of the transaction, including the cost to buyers of accurately predicting the cash flows from the pool. As low-cost substitutes for asset homogeneity (such as larger data sets on the performance of various assets and a variety of forms of credit enhancement) become available, increasingly diverse pools of loans will be securitized.

Changing SEC Regulations to Reduce the Cost of Loan Sales

Structured financings result in securities that are subject to investor protection law and regulation administered by the SEC. One of these statutes is the Investment Company Act, which carries a high cost of compliance for many securitizations. Under Rule 3a-7, adopted by the SEC in November 1992, however, structured financings that meet the rule's conditions are exempted from the act's costly requirements. These conditions, which make a sharp distinction between genuine registered investment companies and structured financings, are intended to encourage the continued evolution of the asset-backed securities market without compromising investor protection. Specifically, to make use of the cost savings made possible by this rule, issuers may sell to the general public only fixed-income securities that are rated at least investment grade. In order to provide further cost savings for many issuers of securities backed by assets,

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27/ For recent developments in small business loan sales see "Market Is Seen in Small Business Loans," *Wall Street Journal*, October 18, 1993, pp. C1, C17.

the SEC has also extended the use of its short-form registration statement (Form S-3) to these entities. Changes in SEC regulations, especially Rule 3a-7, are already credited with making possible at least two securities transactions backed by pools of small business loans. 28/

Implications for Federal Policy

In order to accelerate the development of a secondary market for small business loans, government policy must focus on the causes of its slow development. In fact, small business loans are different from those financial assets that have been securitized heavily, and the differences are precisely those that complicate the task and raise the cost of projecting cash flows from these loans. A borrower's managerial ability and the value of special purpose collateral in a business liquidation are important determinants of the expected cash flow from a small business loan. These factors are much harder to measure and relate to future income prospects than the loan-to-value ratio on a single-family home mortgage.

It is not clear what the federal government can do--beyond current efforts--to effect a major increase in the predictability of cash flows from small business loans. The government has established a loan guarantee program to meet the special credit needs of small business. 29/ Both the guaranteed and unguaranteed portions of these loans have been successfully securitized. Experience with these 7(a)

28/ See Appendices C and E.

29/ See Appendix A.

guaranteed loans is providing lenders and investors with a substantial amount of data that may be used to develop and improve the ability of market participants to evaluate these loans.

CHAPTER IV
LEGISLATIVE PROPOSALS

Legislators have introduced a number of proposals in the 103rd Congress to encourage small business loan securitization. Many of these proposals differ fundamentally in their diagnosis of the market's slow development and, therefore, in their approach to promoting its growth. The four bills summarized here would provide for the creation of a new tax entity to issue securities backed by loan assets; modify a number of securities, banking, pension-protection, and tax laws; certify various entities as secondary market "facilitators" and exempt them from laws and regulations to be identified as obstacles to secondary markets; and create a new GSE to purchase small business loans. 30/

Create a New Tax Entity

H.R. 2065, the Financial Asset Securitization Investment Trust Provisions of 1993, focuses on the current tax code as a cause of the slow development of some secondary markets. The proposal is intended to facilitate the issuance of asset-backed securities by creating a new tax entity for the securitization of loans, called a financial asset securitization investment trust ("FASIT"). If enacted, this bill would provide issuers of all asset-backed securities with a

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30/ Another category of proposals attempts to increase lending to small business without developing a secondary market. It is not treated here, but see, for example, S.479, and Katherine A. Samolyk and Rebecca Wetmore Humes, "Does Small Business Need a Financial Fix?" *Economic Commentary*, Federal Reserve Bank of Cleveland (May 15, 1993).

tax-exempt vehicle similar to those that real estate mortgage investment conduits ("REMICs") afford issuers of mortgage-backed securities.

In the Tax Reform Act of 1986, the Congress exempted from corporate income tax the income of certain entities, called REMICs, through which mortgages are securitized. In this case, income passes through to the investors and is taxable to them. The REMIC is not a taxable entity. One justification for this policy is that these entities are more like bookkeeping arrangements than active businesses. REMICs are unique entities because they hold a fixed pool of mortgages, which are relatively standardized instruments that require little portfolio management. Before 1986, the courts had not decided on the proper tax treatment of these mortgage pools, although the Internal Revenue Service had held that they were taxable entities. The tax status of non-REMIC SPVs remains uncertain.

The FASIT proposal would follow the REMIC example and generally allow entities that pool nonmortgage assets to avoid income taxation at the SPV level. Such entities would have to meet certain requirements, including holding almost all of their assets as loans. The proposal would allow the FASIT to issue "qualified debt instruments" that would be treated as debt for federal tax purposes as long as they did not have yields of more than five percentage points above those of Treasury securities with comparable maturities. The interest on the debt would be deductible in computing the FASIT's taxable income, which would then flow through to the owners of the FASIT's equity interest and be taxable income to them. The legislation would permit other real estate mortgage investment

conduits and domestic corporations to hold equity in REMICs. The corporations could not use net operating losses to offset any taxable income from this source.

The legislation would grant the institutions that originate the loans different tax and financial accounting treatment, essentially permitting the originators to sell the loans to investors and remove them from their balance sheets, even though for tax purposes the investors purchase debt securities, not an equity interest.

Supporters of H.R. 2065 argue that the FASIT rules would lead to an increased availability of credit at reduced cost, make loans more liquid, and broaden the field of actual and potential providers of credit. The benefits are not assured, however; and if they are achieved, the U.S. Treasury will lose some tax revenue. Furthermore, the FASIT proposal does not specifically address small business loans. In fact, its primary advantage is that it would apply to the entire asset-backed securities market, which is developing under a cloud of uncertain tax treatment.

For securitization to be economically attractive, transactions must be designed so that the trust is not subject to federal income tax. In the absence of the FASIT vehicle, taxation of issuer and holder interests requires a case-by-case evaluation and leads to uncertainty and complexity. It is possible that FASIT would be used first to reduce the securitization costs of credit card debt and auto loans, rather than small business loans.

Modify the Securities Pension, Banking, and Tax Laws

The approach, embodied in the Senate passed version of Title II of H.R. 3474, assumes that the accelerated development of a secondary market in small business loans requires changes in several statutes. Accordingly, the Small Business Loan Securitization and Secondary Market Enhancement Act of 1994 would modify the Securities Exchange Act of 1934 and override some state securities and investment limitation laws; and amend federal banking and pension law and regulation. The bill uses the definition of a small business found in the Small Business Act. 31/ By this definition small business includes (1) manufacturers with fewer than 1,500 employees, (2) service firms with sales of less than $13.5 million, (3) wholesalers with fewer than 100 employees, and (4) construction firms with less than $17 million in receipts.

The bill would amend the securities and banking laws and regulations to require that securities related to small business, which must be of investment grade, be treated the same as mortgage-related securities under SMMEA. It would therefore liberalize the regulatory treatment of small business-related securities for such purposes as margin requirements, extensions of credit by broker-dealers, and borrowing in the ordinary course of business by broker-dealers. It would also ease the limitations on purchases of small business-related securities by federally chartered depository institutions. The same override of state securities laws is provided for small business-related securities as was afforded mortgage related securities in SMMEA.

31/ 15 U.S.C. 631 et seq.

The bill also modifies banking law to ease the capital and reserve requirements applicable to qualified depositary institutions with respect to small business loans and leases of personal property. The bill also provides the Secretary of Labor, in consultation with the Secretary of the Treasury, with the authority to grant exemptions under the Employee Retirement Income Security Act of 1974 and the Internal Revenue Code to allow employee benefit plans to invest in small business-related securities.

Aspects of this bill that warrant further study include the effects on federal revenues; the possibility that the loans securitized are those that would have been made anyway, rather than new small business loans; and its imposition of a regulatory outcome on banking agencies that are charged with responsibility for maintaining the safety and soundness of the banking system. In fact, federal banking agencies are currently reviewing the capital requirements for asset sales with some retained liability for credit losses.

Certify Secondary Market Facilitating Organizations

This approach also appears to assume that a number of current laws and regulations have caused the slow development of a secondary market in small business loans, as well as parallel markets for community development loans and equity investments in small business enterprises. It is different from the previous approach, however, in that the laws and regulations that are hindering development are not specifically identified in this legislation.

H.R. 2600--the Business, Commercial, and Community Development Secondary Market Development Act--would authorize the Secretary of the Treasury to certify any person or government unit which meets requirements as a Secondary Market Facilitating Organization ("SMFO") for business, commercial or community development related securities.

In order to obtain and retain the SMFO certification, the entity would have to meet eligibility standards established by the Secretary. These standards would include provisions related to capital requirements; qualifications for directors, officers, and employees; conflicts of interest; and reporting requirements. Secondary market facilitating organizations that do not meet these standards could have their certifications revoked. SMFOs would guarantee, underwrite, buy and sell, or serve as principals in the placement of securities backed by or representing an interest in debt or equity. They would also seek to promote community development, support enterprises in low- and moderate-income areas and enterprises owned by minorities and women, and address credit dislocations. H.R. 2600 was ordered reported by the House Banking Committee on March 9, 1994.

Aspects of this approach that deserve further study include the need to identify those specific provisions of current law that have inhibited the development of secondary markets in debt and equity investments and doubts expressed by members of the financial community that the benefits of SMFO certification would be sufficient to outweigh the costs of complying with regulations issued by the Secretary of the Treasury. These doubts are fueled in part by Section 16 of the bill which states that, "No provision of this Act shall be

construed as affecting the authority of any Federal regulatory agency to supervise or regulate any . . . secondary market facilitating organization."

Create a New Government-Sponsored Enterprise

The Business, Commercial, and Community Development Secondary Market Development Act applies the FNMA/FHLMC/Federal Agricultural Mortgage Corporation ("Farmer Mac") model to small business loan securitization. As detailed in S. 512 and H.R. 660, the Small Business Credit Availability Act of 1993, this alternative would establish a federally chartered but privately owned corporation called the Venture Enhancement and Loan Development Administration for Smaller Undercapitalized Enterprises ("Velda Sue").

Velda Sue would contribute to the development of a secondary market for small business loans either by purchasing the underlying paper, using it to form pools, and issuing its own guaranteed securities backed by these pools, or by guaranteeing securities issued by other certified loan poolers. A small business loan would be defined as an extension of credit to a small business that meets Small Business Administration loan standards or has a net worth of less than $18 million and annual net, after-tax income of less than $6 million. The federal government would provide up to $300 million in temporary capital to Velda Sue, at the request of the corporation and after it has sold $30 million in common stock. These funds would be repayable by Velda Sue over 10 years, beginning 15 years after the date of purchase, and would bear interest based on the average yield on U.S securities with 15-year maturities. As a part of this capital

transaction, the Secretary of the Treasury would also receive warrants to buy nonvoting Velda Sue stock at favorable prices. There is no requirement that Velda Sue request federal capital. Velda Sue would also have a $1.5 billion line of credit at the Treasury to cover losses. This line of credit is the same as Farmer Mac's.

Velda Sue's Board of Directors would specify minimum standards for loans to be purchased by Velda Sue, including a maximum principal amount, a maximum term not to exceed 30 years in the case of land or facilities and 10 years in the case of equipment, and requirements that the loan be fully amortized and that the loan-to-value ratio not exceed 90 percent.

If these conditions were met, Velda Sue could buy 80 percent of the loan with the originating lender retaining 20 percent. In addition, the Secretary of the Treasury would supervise the financial safety and soundness of Velda Sue. In essence, the Secretary would regulate its operations. Any paper issued by Velda Sue or guaranteed by it would not be explicitly guaranteed by the federal government, although its issuance would be subject to the approval of the Secretary of the Treasury.

Velda Sue would be authorized to charge guarantee fees, but these fees are capped at 2 percent of any loan guaranteed, and one half of one percent of any security representing an interest in a pool of these loans. Finally, Velda Sue would be prohibited from providing guarantees or incurring more obligations than 30 times the amount of its capital. This amounts to a required capital-to-asset ratio of 3.2

percent and is less than half the capital requirements for a commercial bank specializing in small business loans.

One disadvantage of such a GSE is that it would use the massive financial resources of the federal government to absorb, as well as to reduce, the uncertainty and credit risk of small business loans. The backing is based on much less historical information than was available to support the federally-financed development of a secondary market for single-family mortgages. Even so, recent experience shows that a government-sponsored enterprise does not necessarily ensure an active secondary market. Farmer Mac has been in operation since 1988, but by the end of 1992 only about $650 million in securities guaranteed by Farmer Mac were outstanding.

In both types of GSEs, statutory restrictions limit the portion of a loan that the GSE can purchase from the originator. This limit reflects the conviction that the originator must be required to assume a substantial credit risk in order to assure sustained high-quality credit extension and servicing. A second disadvantage is that the federal government's contingent, but unrecognized, liability would be increased by the use of a GSE in this instance. A third drawback is that the development of standardized underwriting criteria could harm those businesses that cannot meet them. It is also likely that the businesses that would receive the benefits of a GSE are the ones that currently receive bank loans without government support. Finally, the creation of a GSE could stunt competition and innovation in the marketplace, because if it succeeds, it is likely to become the dominant firm in the secondary market.

APPENDIX A - THE SBA GUARANTEED LOAN MARKET

There is a flourishing market for the government guaranteed portions of small business loans which was made possible in 1959, when SBA obtained permission from the Comptroller General to utilize procedures to be followed in purchasing guaranteed portions of loans from SBA participating lenders. In 1972 lenders commenced trading SBA guaranteed portions of loans between and among themselves for a total of $50 million.

In a series of opinions issued in 1972, 1974, 1976, and 1978, the Comptroller General addressed issues dealing specifically with the operations of the SBA secondary market. In effect, these opinions authorized the unconditional guarantee of the SBA obligation to the secondary market investor, the use of a private fiscal and transfer agent ("FTA"), and the SBA guarantee that the FTA would forward to the investor any payments received from the borrower.

By 1978, secondary market volume was $500 million. In 1979, SBA offered investors and lenders the option of using the services of an FTA. This reduced the paperwork and provided SBA with accurate and up to date oversight capability. It also allowed institutional investors to receive one monthly check covering the payments from a number of loans, instead of the earlier practice of receiving a check for each loan owned by the investor. In 1984, Congress enacted the Small Business Secondary Market Improvements Act (Pub. L. 98-352) which authorized a secondary market loan pooling program and required the use of an FTA as a central registry.

Since that time, the secondary market has grown rapidly. In calendar year 1992, SBA participating lenders sold the guaranteed portion of 8,272 7(a) loans for $2.1 billion. In dollar terms, this represents approximately 50% of the guaranteed portion of all 7(a) loans made during 1992 with an additional $1.3 billion in retrades of loans already held by investors. The aggregate amount of SBA guaranteed portions of 7(a) loans in the secondary market at the present time is approximately $7 billion, and this represents 35,000 loans. Virtually all of these purchases of SBA individual loans and pools are by institutional investors.

Under Section 7(a) of the Small Business Act, SBA has the authority to guarantee up to 90% of the principal amount of a 7(a) loan made by a bank or other lending institution to an eligible small business. An SBA guaranteed portion may be sold directly to a third party investor on the secondary market or it may be pooled with similar guaranteed portions in which case certificates backed by such pools are sold to investors.

SBA's secondary market activities involve a number of participants. Under the Small Business Secondary Market Improvements Act, SBA has promulgated regulations which prescribe rules and procedures for the operation of the secondary market for the guaranteed portion of 7(a) loans. Originating lenders may sell individual guaranteed portions directly to investors or may use the services of a securities dealer who re-sells to the ultimate investor. Such an investor purchases the entire guaranteed portion of a specific loan. In addition, there is an active network of pool assemblers (including lenders) who acquire the guaranteed portion of 7(a) loans

of similar maturities and interest rates which are then grouped or pooled for sale to investors. The investor may then purchase SBA guaranteed certificates which represent an interest in a pool of guaranteed portions of 7(a) loans.

Under SBA's regulations, a lender can earn fee income for servicing its entire small business loan portfolio even though it has sold the guaranteed portions of the 7(a) loans and has retained only the remaining unguaranteed portions. In addition, the lender may receive a premium on the sale. That premium is an amount, paid by the investor, in excess of the principal balance, which adjusts the yield to market rates. Thus, the yield on the lender's investment in the SBA guaranteed loan could be increased when it sells the guaranteed portion. Further, the lender obtains greater liquidity by selling the guaranteed portion, and with that increased cash flow, the lender can make additional loans (SBA guaranteed or conventional) to other businesses. This allows a lender to increase market share and it provides opportunities for the lender to sell other financial services to its business customers. Except for certain specific situations which require prior SBA approval, lenders which sell the guaranteed portions of 7(a) loans must retain ownership of the unguaranteed portions. The retention of this risk helps to ensure that the lender makes a thorough credit analysis and that it properly services each 7(a) loan. Because the lender retains servicing responsibility for a 7(a) loan, the guaranteed portion of which is sold in the secondary market, the small business borrower continues to make its monthly payments to, and thereby creates a valuable long term relationship with, its lending institution.

SBA utilizes the services of an FTA to monitor all 7(a) loan guaranteed portions sold in the secondary market. The FTA is the central registry for all paperwork involved in the secondary market. It creates the sale record when the guaranteed portion is sold in the secondary market, creates the file for a pool of guaranteed portions of 7(a) loans, tracks all subsequent sales, processes borrower payments made to it from the lenders, and forwards those payments to investors in individual guaranteed portions and investors in pools of guaranteed portions. The FTA receives payment for its services through transaction fees and not through government funds.

When a participating lender and an investor negotiate the terms of a sale of an individual guaranteed portion of a 7(a) loan into the secondary market, they and SBA execute a Secondary Participation Guarantee and Certification Agreement. This agreement, together with a copy of the borrower's note and a confirmation of sale letter, is sent to the FTA which reviews the documentation and establishes a computer record for the sale. On settlement day, the purchaser wires money to the FTA which forwards these funds by wire to the lender on the same day. Within two business days, the FTA issues a certificate of ownership to the purchaser.

The original investor in a guaranteed portion sold on the secondary market may resell that guaranteed portion. When the investor resells the guaranteed portion of a 7(a) loan, it endorses and delivers the certificate to the new purchaser.

As mentioned above, many guaranteed portions are sold in the secondary market as part of a pool of guaranteed portions of 7(a)

loans. Under the pooling program, private sector pool assemblers, which have been approved by SBA, purchase guaranteed portions of 7(a) loans from lenders and aggregate them into pools. Pool assemblers can only pool loans whose terms and conditions are similar and they must ascertain that the borrowers are current on their obligations when the pools are formed.

An investor who purchases an individual guaranteed portion of a 7(a) loan receives SBA's unconditional guarantee to pay principal and interest, accrued to the date SBA honors its guaranty if such loan goes into default. An investor who purchases an undivided interest in a pool of guaranteed portions of 7(a) loans in which an underlying 7(a) loan goes into default will be paid its proportionate share of the principal and interest of the guaranteed portion of that loan when SBA repossesses the guaranteed portion from the pool. In addition, SBA guarantees to pay into the pool any unpaid principal and interest which accrued, after an underlying 7(a) loan defaults, so that the schedule of principal and interest payments continues without interruption until SBA actually purchases the guaranteed portion of the defaulted 7(a) loan. As a result, the payment stream to a pool investor is predictable. In this way, SBA's guarantee has contributed to the success of the pooling program. Also because of the unconditional guarantee, these securities are exempt from the registration requirements of the Securities Act of 1933 (the "Securities Act").

APPENDIX B - THE PROCESS OF SECURITIZATION

What is Securitization?

"Securitization" refers generally to the issuance of securities representing an interest in a segregated pool of financial assets which convert into cash over finite time periods. The purpose of segregating the financial assets, by use of a trust or other SPV, is to isolate those assets from the risk of bankruptcy of the originator. This may be effected by establishing a "bankruptcy-remote" SPV (i.e., one that is protected from bankruptcy under various structural and legal criteria). The securitization is effected in several essentially simultaneous transactions involving a "true sale" of the financial assets to the SPV, with the source of payment for such assets deriving from the proceeds of the issuance of the security interests to investors. The security interests in such SPV represent either an ownership in, or an obligation of, such SPV. In either instance, payments on the security interests are supported primarily by the payment streams generated by the pool of financial assets.

Stated more simply, and for example, a pool of mortgage loans, producing periodic payments of interest and/or principal, are assembled and transferred to an SPV. Pursuant to the terms of operative documents, the stream of interest and principal payments is "carved up" for distribution to classes of security holders, each of which has different priorities to, and allocable interests in, such payment streams.

Credit Enhancements

To compensate for uncertainty relating to asset performance, credit enhancement mechanisms are included which enhance asset quality by providing monies which supplement the cash flow generated by the underlying assets. Such enhancement mechanisms are drawn upon to cover delinquencies, defaults or other losses on the underlying assets. Most asset-backed financings include some form of credit enhancement. The amount of credit enhancement needed for a particular asset pool depends upon the historical performance of the assets, the structure of the transaction, and the credit rating necessary to sell the securities.

There are two categories of credit enhancements -- external and internal credit enhancements. External forms of credit enhancement, such as bank letters of credit and financial guaranty insurance, may be provided by third parties with an investment-grade credit rating. These instruments obligate the issuing bank or insurer to pay up to a specified percentage of the pool assets in default. The percentage is usually far below the full dollar amount of a pool's outstanding principal amount, but is above the historical default rate of a similar portfolio of assets. Also, the sponsor of a pool may provide a guarantee or agree to extend recourse to cover any losses up to either a fixed dollar amount or fixed percentage of the declining principal balance of the financing. These forms of external credit enhancement may be used alone or, more commonly, in conjunction with some other form of credit enhancement.

Over the past several years, there has been a decrease in the use of external forms of credit enhancement due to downgrades in the credit ratings of the third-party providers. 1/ This decline in credit quality has led sponsors to turn to internal forms of credit enhancement. Internal credit enhancements are structural protections inherent in the design of the financing. For example, a sponsor can use "subordination" to provide credit enhancement to investors by issuing senior and subordinated classes of securities out of the same pool, with the former having priority to the cash flows from the underlying assets. The subordinated class bears the brunt of any credit losses before any amounts are charged to the senior class. The sponsor or its affiliates also may retain an equity or residual interest in the pool, thus subordinating its own interests to the interests of investors. 2/

1/ See, United States Securities and Exchange Commission, Division of Investment Management, "The Treatment of Structured Finance under the Investment Company Act," *Protecting Investors: A Half Century of Investment Company Regulation* (May 1992) note 1, at p.60. Noting that, until recently, most LOCs have been provided by foreign commercial banks, primarily because of the limited number of AAA-rated United States banks; however, recent downgrades in the ratings of these foreign banks have caused sponsors to turn to other forms of credit enhancement.

In 1988, bank letters of credit accounted for 58% of the credit enhancements in asset-backed financings. By 1991, that figure had dropped to 15.3%, and by the first half of 1992, letters of credit accounted for 4.4% of the credit enhancements provided. The use of surety bonds as a form of credit enhancement over the same five-year period fluctuated between 7.4% and 17.2%, demonstrating no discernible trends. Dean Witter, "Asset Backed Securities Reference Guide," A-19 (1992) ("Dean Witter Guide").

2/ Residual interests are typically unrated and highly volatile in nature, with payment depending in part on the effects of prepayments on the underlying assets and/or changes in interest rates on the cash flow. These interests are usually the first class of securities to bear any

Another common form of internal credit enhancement is "over-collateralization" which results when the sponsor places an aggregate principal amount of assets in the pool which exceeds the aggregate principal amount of securities issued. The cash flow from the excess collateral is intended to offset defaults or delinquencies on the assets.

Other internal forms of credit enhancement, typically employed in conjunction with other enhancements, include "reserve funds" (also called "cash collateral accounts") where cash is placed in a segregated account maintained by a trustee for the benefit of security holders and may be drawn upon by the trustee or servicer over the life of the financing, as needed. A "spread account" may also be used to hold funds in escrow which represent the difference between amounts earned on the assets in the underlying pool and amounts needed to pay servicing fees and interest on the securities.

Typically, multiple forms of these internal credit enhancement are used by sponsors in structured financings. By 1991 and the second half of 1992, some form or combination of internal enhancement was present in over 80% of the credit-enhanced financings. 3/

To obtain a AAA rating from one of the rating agencies it has been estimated that the amount (expressed as a percentage of the aggregate principal pool balance) of internal credit enhancement (e.g.,

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losses in the event of insufficient cash flow. See Investment Company Act Release No. 18736 (May 29, 1992).

3/ Dean Witter Guide, supra note 1.

over-collateralization, reserve funds, subordination) necessary for revolving small business loans is 18% to 25%. SEC staff experience in reviewing registration statements involving asset-backed securities confirms that internal credit enhancement levels may vary between 5% and 37% of the aggregate principal pool balance depending upon the nature and structure of the asset-backed transaction.

Master Trusts

A further market development which has facilitated the expansion of asset-backed securitization is the development of the "Master Trust." Master Trust arrangements involve the transfer of a relatively large volume of financial assets (in this case, small business loans) to a trust entity. From time to time thereafter, the master trust will issue "series" of certificates representing an undivided fractional interest in the pool of financial assets ("Investor Interest"). The stated principal amount of any such series typically represents only a portion of the aggregate principal amount of financial assets transferred to the master trust. A "residual" interest in the pool of assets is retained by the transferor ("Transferor Interest") and, while initially such Transferor Interest may be considerably larger than the Investor Interest(s), such Transferor Interest is subject to reduction as additional series of Investor Interests are issued. 4/

4/ Note that the terms of any additional series will not be subject to the prior review or consent of holders of certificates of a previously issued series. The terms of such additional series may include different methods for determining such series' allocable interest in the pool and provisions for other forms of credit enhancement. Typically, it is a condition to the issuance of any additional series that the creation of the new series will not result in the rating agency which rated outstanding series reducing or withdrawing its rating on such outstanding series.

Any particular series will typically provide for a period of time after issuance when only interest payments are made on the certificates; principal payments on the certificates either are paid in a single "bullet" payment at maturity (perhaps with a provision for accumulation of principal collections on the underlying assets in a segregated account controlled by either the sponsor or the trustee), or are paid over an "Amortization Period" which commences two or more years after issuance of the certificates. During the period from issuance until commencement of such an Amortization Period (frequently called a "Revolving Period"), collections of monies on the underlying assets, to the extent available after application to required payments on other series outstanding, may be utilized by the sponsor/originator of the trust to generate additional loans securing the certificates.

Because series of certificates may be issued from time to time, one series may be in a Revolving Period while another series may be in its Amortization Period. Master Trust arrangements will usually provide for the accumulation of finance charge/interest collections and principal collections on the underlying assets in separate accounts and allocation of such collections to any series outstanding which, pursuant to such series' terms, is at such time entitled to interest or principal payments.

The development of the Master Trust arrangements serves at least three significant purposes. First, by establishing a pool which is significantly larger than the pool size for a single, discrete securitization, the sponsor attempts to create a pool which more closely replicates the performance of the sponsor's portfolio. For

example, in the Fremont deal, a substantial majority of the loans originated by Fremont were transferred to the master trust. As a result, loan performance information which Fremont maintained on its portfolio was more likely to be replicated in the master trust than if a single, smaller pool of loans was securitized to effect one discrete deal.

Second, the master trust facilitates 'parity' in spread protection for series issued at different times. One source of protection against poor asset performance for certificate holders is the protection "built-in" to a securitization which results from the spread in yields between the underlying assets and the publicly-offered certificates ("yield spread"). Frequently, a "spread account" will be established in a securitization which is partially or fully funded at the time the trust is established and serves as the first source of funding in the event of delinquency or loss experience on the underlying assets. The spread account is funded and, as draws are made upon it, is replenished from interest payments on the underlying assets in excess of that necessary to meet the payment obligations on outstanding certificates. Thus, a larger yield spread conveys more assurance that such credit enhancement feature will be maintained. Because series offered from time to time must be priced competitively, the yield on the certificates of one series will likely differ from the yield on another series. Through the master trust's mechanism whereby finance charge/interest collections are aggregated and then allocated to the interests of all series outstanding, a 'parity' in spread protection is created for all such series.

Third, as compared with the single offering/single pool deals, the master trust arrangement is a lower cost means of effecting securitizations because it allows a sponsor to form a single trust from which it can effect multiple securitizations while retaining maximum flexibility in the structure and terms of the series issued.

APPENDIX C - COMPLETED SMALL BUSINESS LOAN SECURITIZATIONS

Fremont Small Business Loan Master Trust 1/

Fremont is engaged in commercial finance lending. Such loans are primarily revolving and short-term (two years), and are secured by assets including: accounts receivables, inventory, machinery, equipment, and, to a lesser extent, real estate. The majority of Fremont's customer base consists of small to medium size manufacturers and distributors.

Fremont, through its affiliate Fremont Funding, Inc. ("Transferor"), has established the Fremont Small Business Loan Master Trust ("Trust") and has transferred to such Trust a substantial majority of the loans in its portfolio ("Fremont Portfolio"). The primary trust asset is the right to repayment of loan advances ("Advances") generated from time to time in a pool of revolving commercial finance loans.

In April 1993 the Trust publicly issued $200 million triple-A rated Variable Rate Asset Backed Certificates, Series A ("Series A Certificates"), representing an undivided fractional interest in the Trust ("Investor Interest"). An interest in the Trust is retained by the

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1/ Fremont has made two public offerings of securities backed by small business loans; $200 million worth of such securities were offered in April 1993 and $100 million worth of such securities were offered in November 1993. Further, in June 1994 Fremont registered for offer and sale on a delayed basis up to $450 million worth of additional securities backed by small business loans. The description in this appendix relates to the April 1993 offering.

Transferor and represents essentially the right to repayment of Advances not allocated to the Investor Interest ("Transferor Interest").

Interest payments on the Series A Certificates will be paid monthly in an amount equal to the lesser of: (i) LIBOR (determined monthly) plus 0.47% per annum, or (ii) the weighted average of the finance charges that accrued on the Advances during the relevant monthly period, minus a 2% servicing fee percentage. Principal payments will commence three years after issuance [March 1996] and will continue for up to two years, until fully paid.

Credit support for the Series A Certificates is provided through a subordination feature whereby a portion of the Transferor's Interest, such portion equal to $46.914 million [19% of the aggregate principal balance of the Series A Certificates], is subordinated to the interest of the Series A Certificate holders in monies generated by the Advances ["Subordinated Amount"]. 2/ As loans become delinquent or are

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2/ To obtain a AAA rating from one of the rating agencies it has been estimated that the amount (expressed as a percentage of the principal pool balance) of internal credit enhancement (e.g., over-collateralization, reserve funds, subordination) necessary for a particular type of collateral generally is as follows:

residential mortgages	8 to 12%
commercial real estate	
- multi-family	10 to 20%
- mixed use	20 to 40%
small business loans	
- revolving	18 to 25%
- secured by real estate	20 to 35%
credit card receivables	10 to 15%
automobile loans	8 to 13%
computer leases	10 to 15%

charged-off as losses, the Series A Certificates will continue to be paid in full until such time as the Subordinated Amount is exhausted. In addition, in the event the Transferor's Interest does not represent an interest in the trust assets sufficient to achieve the Subordinated Amount, an Excess Funding Account will be maintained and funded (through the allocation of payments under the Advances in excess of amounts necessary to pay interest on outstanding series of certificates, and servicing fees) until, when aggregated with the Transferor's Interest, the Subordinated Amount is again reached.

Notable characteristics of the Advances transferred to the Trust include, measured as a percentage of outstanding principal balance: (i) 31.2% of the total Advances were to obligors located in California, and (ii) 58% of Advances were in the $1 million to $3 million range [see chart below].

Loan Size Range	Net Portfolio (in millions)	Percentage
Under $1 million	$27.2	13%
$1 million to $2 million	$64.2	32%
$2 million to $3 million	$51.7	26%
$3 million to $4 million	$27.1	13%
$4 million to $5 million	$21.5	11%

These ranges are necessarily broad due to the fact that the rating agencies do not apply a fixed formula based upon asset type -- numerous factors are applied to each individual transaction to take into account the specific structure of the transaction, the quality of its participants, and the particular credit quality of the assets pooled.

Overall, SEC staff experience in reviewing registration statements involving the above asset-backed categories confirms that internal credit enhancement levels may vary between 5% and 37% of the aggregate principal pool balance depending upon the nature and structure of the asset-backed transaction.

TMS SBA Loan Trust 1993-1

The Money Store Investment Corp. and The Money Store of New York, Inc. (collectively, the "The Money Store") have originated SBA loans since approximately 1980. The Money Store has been the largest originator of SBA guaranteed loans since 1983, originating approximately $257 million during 1992 and, as of the 1992 year-end, servicing a portfolio of SBA loans aggregating approximately $1 billion. Loans are typically secured by owner-occupied commercial real estate, but additional collateral such as liens on all personal assets, personal guaranties, and/or machinery and equipment may be required.

The Money Store created TMS SBA Loan Trust 1993-1 ("Trust") and transferred to it the right to receive payments and other recoveries attributable to the unguaranteed interests ("Unguaranteed Interests") in a pool of loans partially guaranteed by the SBA. The guaranteed interest varies from SBA loan to SBA loan and is not included in the Trust assets; certificate holders have no right or interest in this component.

In April 1993 the Trust issued $69.353 million triple-A rated Class A Certificates and $6.859 million single-A rated Class B Certificates which evidence the entire beneficial ownership interest in the Trust. The Class B Certificates are subordinated to the Class A Certificates in right to receive both interest and principal payments. A "residual" interest is retained by The Money Store in that all monies generated monthly by the loans, which are not needed to pay fees associated with the servicing, certificate interest and principal, or for

reimbursement to the servicer or to reserves, are released to The Money Store.

Interest and principal on the certificates is payable monthly. Interest is payable at a floating rate (adjusted quarterly) indexed to the prime rate. Principal payments commence with the first month after issuance of the certificates. As the underlying loans are self-amortizing, no balloon (refinancing) risk exists.

Credit support for the Class A Certificates is provided through two sources: (i) a "Spread Account," and (ii) subordination of the Class B Certificates. The Spread Account will be partially funded by an initial deposit equal to 2% of the original pool principal balance. The Spread Account will thereafter be funded through excess spread 3/ until the balance is the greater of (i) 4% of the current pool principal balance, or (ii) the initial deposit. Additional excess spread will be deposited up to the amount of the aggregate balances of all loans delinquent 180 or more days. The subordination of the Class B Certificates has the effect of providing the Class A Certificates with additional protection against poor loan performance in an amount equal to 9% of the original principal balance of the Class A Certificates. The only credit support for the Class B Certificates is provided by the Spread Account.

3/ As discussed in Appendix A, there exists a well-established secondary market for the guaranteed portion of the SBA loan and such portions generally are sold in such market at coupons of approximately 100 basis points less that the underlying loans. As a result, the interest which accrues on the guaranteed portion of the principal balance of each SBA loan exceeds the sum of the interest payable to the holder of the guaranteed interest. Such "excess spread" is included in the Unguaranteed Interest and will be a source to fund a Spread Account.

A liquidity feature is included by means of the servicer's obligation to make advances (on a monthly basis) to the extent not covered by excess spread. However, such obligation is conditioned upon the servicer's determination that any such advances are recoverable in subsequent periods.

APPENDIX D - REASONS FOR THE SLOW DEVELOPMENT OF SMALL BUSINESS LOAN SECURITIZATION

While only two public securitizations of small business loans have come to market to date, they do suggest that the threshold question of the feasibility of such securitizations may be answered in the affirmative. However, both in absolute terms and as compared with growth in securitization of automobile loans and credit card receivables, the development of securitization in small business loans has been seemingly inhibited. This section of the appendix will address possible reasons for this slow development and suggest some solutions.

Difficulty in Estimating Expected Loan Loss and Predicting Cash Flow

One of the principal hurdles impeding the development of small business loan securitization is the difficulty of estimating expected loss on such loans. This is particularly difficult with respect to small business loans, as those loans are heterogenous in nature, with borrowers of differing credit qualities and a relatively wide variance in collateral, interest rate, amortization, covenants and documentation. With residential mortgage securitization GSEs reduce investors' high cost of information about borrowers by guaranteeing the timely receipt of principal and interest payments, thereby eliminating credit risk. In the context of small business loans, no comparable mechanism is in place to mitigate a credit risk which the market may perceive to be greater since loans have more individual characteristics.

The ability to estimate accurately levels of loan loss facilitates establishing asset quality and, hence, the level of credit support needed to make such asset-backed securities marketable. The less reliable the loan loss data, the more credit enhancement required, increasing the cost of securitization.

In The Money Store securitization investors and the rating agencies were able to assess the likely risk of loss because all the loans had been originated by the same affiliated lenders and those lenders had historical bad-debt data. In addition, the security for each loan was homogenous. Similarly, in the Fremont deal, the likely risk of loss could be estimated because Fremont had collection experience for its portfolio for the preceding three years. In addition, the loans were well diversified as to industry and no one obligor owed more than 3% of the total (no "borrower concentration").

A related hurdle -- the ability to predict levels and timing of cash flow on the underlying loans -- is a serious challenge because small business lending frequently takes the form of a line of credit which revolves. The amount of outstanding loan balances can vary widely from day to day making it difficult to predict when and how much the borrower will use its line and when it will pay down the borrowings it has made. This concern, however, is not unlike the situation with credit card receivables. As with credit card deals, if the lending institution is the originator of the SPV, the SPV could purchase an undivided interest in a pool of qualifying loans on the books of the lending institution, such that, although the total amount in the pool would vary from day to day, the SPV's investment would not change because the lending institution would absorb any daily fluctuations.

In the residential mortgage area, principal payment patterns, including prepayments, are not necessarily any more predictable. Models have been adopted which make certain basic assumptions, including constant rates of prepayment, but such models are primarily employed to exhibit the sensitivity to changes in prepayment rates of a particular class of certificates relative to another class of certificates representing interests in the pool of assets. Thus, while cash flow predictability will facilitate securitization efforts, the absence of reliable data is not as critical as data relating to loss experience.

These difficulties do not, however, seem to be an insurmountable hurdle. An industry trade association or the SBA could undertake this task. The SBA is well-positioned to collect loan payment data on a nationwide basis. The SBA already does this for its guaranteed loans and technological advancement is reducing the cost and enhancing the possibilities in this area.

Absence of Standardization

As used herein, the term "standardization" refers to the application of established and pre-determined industry-wide underwriting criteria and loan documentation procedures in connection with loan originations. This concept should be distinguished from the term "uniformity," used in this report to refer to loan originations from a single lender applying its own underwriting guidelines, whether or not standardized. Both the Fremont and The Money Store small business loan securitizations involved "uniformity" in loan originations since all loans in their respective pools were originated by a single lender or

group of affiliated lenders. Commentators have noted that this uniformity facilitated securitization of the loan pools notwithstanding the absence of national standards to which such underwriting criteria and loan origination procedures conformed.

A threshold question is whether or not standardization of small business loan underwriting criteria is necessary for securitization to take place. As discussed previously, securitization of residential mortgages was facilitated by the presence of GSEs which imposed national underwriting and loan documentation standards on loan originators as a condition to GSE purchase or guarantee of such loans. Such standardization reduces the cost and effort necessary to evaluate the quality of the asset pool because inspection or review of each lending arrangement can be replaced with verification that adherence to preset standards for loan origination has been maintained.

However, representatives of both investment banks and rating agencies have expressed the view that virtually any type of financial asset can be securitized, whether or not such assets were originated pursuant to standardized criteria and procedures. And this view is supported by actual experience. In the years since residential mortgages were first securitized, the market has seen more and more instances of securitizations involving pools of assets of which were not originated pursuant to standardized underwriting or loan documentation criteria, examples being the securitization of non-conforming residential mortgage loans, of commercial mortgage loans and, most recently of small business loans.

Another threshold question is whether or not standardization is appropriate for small business lending. Some commentators have expressed the view that small business loans are "character loans" involving many non-quantifiable and subjective factors which are not susceptible to standardization. Standardization would, therefore, be inappropriate since meaningful underwriting criteria may require significant subjective elements. Efforts to standardize underwriting criteria could, therefore, have an adverse effect on the availability of credit to small business borrowers because lenders would not make loans outside the parameters of the standardized underwriting criteria even if other factors suggested that the financing was suitable.

Another challenge to the idea of standardizing small business loan underwriting criteria relates to the nature of the lending arrangement and its ongoing servicing. Commentators experienced in small business lending assert that restructuring the terms of the lending arrangement, including the payment terms, is a common and necessary aspect of the such lending, as the economic conditions in which the borrower finds itself change. They suggest that the necessary flexibility to renegotiate the lending terms does not harmonize with the notion of securitization. This basis for challenging the idea of standardization is less persuasive in light of the Resolution Trust Corporation's ("RTC") successful public securitizations of commercial mortgage loans where discretion to "re-work" the loan terms is retained by the RTC in its capacity as receivor. While this aspect of small business lending may not be a theoretical impediment to securitization, it may be a factor that influences market perception of small business loan securitization and, therefore, may be a practical impediment.

Assuming standardization is both necessary and appropriate, the benefits which flow could include: (i) assuaging public concern over credit quality of underlying loans; (ii) decreasing due diligence costs (and, therefore, the costs of securitization) associated with evaluating credit quality of the loans; (iii) a means by which to statistically analyze the asset pool; and, (iv) a means by which to develop a ratings structure for small business loans.

Standardization could be established through several forums, including the SBA, or through a trade association of industry participants. The SBA could use its nationwide presence to encourage and facilitate the use of standard forms and underwriting criteria. If a GSE were created, it could be the source of such standards.

Level of Loan Demand

Excess demand from creditworthy borrowers and insufficient capital supplies were factors which accelerated the development of securitization in the residential arena. Whether these factors are as significant in the small business loan market, on a nationwide basis, is an open question, particularly in the case of depository institutions. 1/

Finance companies (such as Fremont and The Money Store), on the other hand, depend in large part on the capital markets to fund their loan portfolios. With the tremendous growth in their business loan portfolios, securitization of their portfolio of small business loans

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1/ See Chapter 1.

could be an important source of funding that would support increasing growth in loans. The majority of SBA guaranteed loans sold in the secondary market are those made by non-bank lenders. A viable secondary market in non-guaranteed loans could provide financial companies with additional funding sources, possibly increasing competition for small business loans. In turn, this increasing competition to bank financing could not only expand sources of funds, but also lower costs of such loans. Depository institutions may then look at securitization as a means to lower the cost of small business loans.

Absence of Asset Homogeneity

Loans to small businesses are heterogenous in nature, with borrowers of differing credit qualities and a relatively wide variance in collateral, interest rate, amortization, covenants and documentation. Early experience with asset-backed securities relied heavily upon the pooling of similar assets to limit transaction costs. The market has, however, developed methods to reduce this reliance upon asset homogeneity. The benefits of diversity in loan assets, including reduction of volatility of loan income, also have been recognized. In light of these more recent developments, an absence of asset homogeneity with respect to small business loans is of decreasing significance as a barrier to securitization. For a more complete discussion of the declining importance of asset homogeneity in securitization, see Chapter III.

Economic Incentives to Securitize

As noted above, the precipitating factors which gave rise to development of securitization in the home mortgage market may be distinguished from those which gave rise to the development of securitization in the automobile loan and credit card receivables markets. In the home mortgage market insufficient supply of capital and excess demand from borrowers contributed to the development of a secondary market. In the auto loan and credit card receivables markets the primary catalyst appears to be that securitization offers a less expensive financing option for business operations. The extent to which these factors exist in the context of bank lending to small business is not clear. Creation of a liquid, secondary market alone will not increase bank lending; economic incentives to lend must exist. In the case of non-depository institutions, these factors are present.

The SBA may be in a position to decrease the cost of securitization by developing a mechanism which would overcome the small size of any one lender's portfolio. A computerized market place could be set up that would allow lenders to sell one loan at a time to various entities that assemble pools.

Particular Characteristics of Small Business Loans That Effect The Cost of Securitization

The costs of securitizing small business loans are, in many cases, substantially higher than other financial assets, due to the combination of a variety of factors. Combined with heterogenous nature of small

business loans and absence of standardization, securitization may not be a less expensive vehicle for funding lending operations.

Further, some commenters have noted that the unique relationship between small business borrowers and lenders, both through the level of information conveyed in the origination process and through the ongoing maintenance of the loan, creates an imbalance in information relating to loan/borrower quality between lenders and the secondary market. Although the nature of the lender-borrower relationship in small business loan origination may be more intensive than in other loan origination contexts, concern relating to asymmetric distribution of information potentially could be a concern in almost any securitization. Yet the flourishing marketplace for asset securitization has not seen this concern materialize. Several safeguards seem to explain why asymmetric distribution of information has not emerged as a distinctive problem:

First, a lender's status as a reputable participant in the secondary market will directly affect its ability to access on a continuing basis the public markets as a financing source.

Second, the lender, or perhaps a purchaser from the lender, who pools the loans of several lenders to effect the securitization, is subject to liability under the securities laws for misleading disclosure in connection with the offer and sale of the securities.

Third, the process of securitization involves many participants independent of the lender who have economic and other incentives to ensure loan quality, including: third party credit enhancement

providers whose exposure is heightened when loan quality erodes; underwriters in connection with distribution of the securities who perform "due diligence" activities to determine loan quality and are subject to liability under the securities laws if they are negligent; rating agency involvement assessing and applying numerous factors toward the end of establishing loan quality and, ultimately, the quality of the securities being distributed.

Fourth, in connection with the securitization transaction, lenders provide certain standard representations and warranties regarding loan performance which require loan substitution for a limited period of time in the event a pooled loan or loans fail to conform to such representations.

Some have suggested that the lender retain some risk on the performance of the assets, by guarantee or retention of an interest in the assets. This retention of liability for loss eliminates incentives that a lender might have to sell poor quality loans. A current impediment to use of such a structure, in the case of depository originators, is the requirement that, if any risk is retained by such depository originator, the depository's capital requirements are not reduced by the sale. When a depository originator has no excess of capital it will not be able to sell existing loans to finance additional lending. 2/

2/ Charles T. Carlstrom and Katherine Samolyk, "Securitization: More than Just A Regulatory Artifact," *Economic Commentary*, Federal Reserve Bank of Cleveland (May 1, 1992).

APPENDIX E - SECURITIZATION UNDER THE FEDERAL SECURITIES LAWS

General

Offerings of asset-backed securities are subject to the federal securities laws and must either be registered under the Securities Act or effected in reliance on an exemption from registration, for example in a private placement. In either event such offerings are subject to the general antifraud provisions of the federal securities laws which provide that offering materials shall not contain an untrue statement of a material fact or omit to state a material fact necessary to make the statements in such offering materials not misleading.

Investment Company Act of 1940

Until 1992, a significant barrier impeding small business loan securitization was the Investment Company Act. Many structured financings fall within the definition of investment company under the Investment Company Act, but are unable to comply with many of its requirements. Therefore, structured financings generally had to rely upon specific exemptions under that act (section 3(c)(5)), or be sold only in private placements (section 3(c)(1)) or overseas--depending solely on the assets securitized. (Certain securitizations sponsored by government-sponsored enterprises may be exempt from the act by section 2(b)). In addition, the SEC has issued over 125 exemptive orders, primarily for mortgage-related financings.

In November 1992, the SEC adopted Rule 3a-7 which exempts structured financings that meet the rule's conditions from the Investment Company Act, without regard to the assets involved. The conditions are intended to identify the operational distinctions between registered investment companies and structured financings, permit the continued evolution of the structured finance market, and address any investor protection concerns. The rule is designed to codify the current attributes of the structured financing market.

To rely on the rule, issuers must be in the business of acquiring and holding eligible assets (broadly defined to encompass all types of assets that can be securitized), and may not issue redeemable securities. Issuers may sell to the general public only fixed-income securities that are rated at least investment grade. The rating requirement is intended to address the structural integrity of the financing.

Fixed-income securities that are rated below investment grade or that are unrated may be sold to so-called "institutional accredited investors" (defined in rule 501(a)(1), (2), (3), and (7) under the Securities Act). Other securities issued by a structured financing vehicle (including residual interests) may be sold to qualified institutional buyers (defined in rule 144A under the Securities Act) and to certain persons related to the financing. Issuers must use reasonable care to ensure that securities not eligible for sale to the public are resold only to the appropriate category of sophisticated investors.

The rule does not permit financings to engage in active management of assets, a typical practice of most management investment companies, but does allow limited flexibility to acquire or dispose of assets. Acquisitions and dispositions of assets may not result in a downgrading of the rating of the financing's outstanding fixed-income securities. Also, issuers may not dispose of assets primarily for the purpose of recognizing gains or preventing losses resulting from market value changes.

Finally, the rule requires issuers (excluding asset-backed commercial paper programs) to take reasonable steps to cause an independent trustee to have a perfected security interest in the primary assets being securitized.

Securities Act of 1933

To provide significant cost savings, efficiency and flexibility for many issuers, the Commission also expanded the availability of Form S-3, the short-form registration statement under the Securities Act, to additional issuers and classes of transactions. The expanded availability of Form S-3 also extended the benefits of Rule 415, the shelf registration rule, to a greater variety of offerings, including investment grade asset-backed securities offerings. Changes to the prospectus filing rule, Rule 424, were adopted to accommodate the special timing constraints in connection with offerings of mortgage-related and other asset-backed securities.

Three principal changes to the Form S-3 eligibility requirements were made. First, the reporting history necessary to register on Form S-3 was reduced from 36 to 12 months for most issuers. Second, the aggregate market value of the issuer's voting stock held by non-affiliates (referred to as the "public float") qualifying an issuer for use of Form S-3 for any of its securities was reduced from $150 million to $75 million, and the 3 million share trading volume test was eliminated. Third, Form S-3 was amended to specifically permit registration of investment grade asset-backed securities without regard to whether the issuer or registrant has a reporting history.

Because shelf registration is available for offerings registered, or eligible to be registered, on Form S-3, 1/ these changes to Form S-3 also extend shelf registration to these newly eligible issuers and offerings. Thus, Rule 415 shelf registration is now available for offerings of investment grade asset-backed securities whether registered on Form S-3 or one of the SEC's other registration forms, such as Form S-1 or Form S-11. In addition, a proposed revision to the prospectus filing rule has been adopted as proposed to accommodate the special timing constraints present in asset-backed securities offerings. Under this revision, prospectus supplements containing price and other offering information for asset-backed securities offerings may be filed within two business days following first use, rather than two business days following the earlier of pricing or first use as was previously required.

1/ See Rule 415(a)(1)(x).

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