Board of Governors of the Federal Reserve System
U. S. Securities and Exchange Commission

Report to the Congress on Markets for Small-Business- and Commercial-Mortgage-Related Securities

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Submitted to the Congress pursuant to section 209
of the Riegle Community Development and Regulatory Improvement Act of 1994

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I. Executive Summary and Introduction

Section 209 of the *Riegle Community Development and Regulatory Improvement Act of 1994* (the Riegle Act or Act) requires the Board of Governors of the Federal Reserve System and the Securities and Exchange Commission (hereafter, the agencies) to submit a joint study by September 23 of 1996, 1998, and 2000, addressing the effect of that legislation on

- the structure and operation of the markets for securitized small-business loans and commercial mortgages
- the availability of credit for business enterprises.

The Riegle Act also requires the agencies to consider recommendations for further legislative or administrative action.[1] This is the second report submitted in accordance with these requirements.

Like the *Secondary Mortgage Market Enhancement Act of 1984* (SMMEA), which removed regulatory obstacles to the securitization of residential mortgages, the Riegle Act was designed primarily to remove legal hindrances to the development of markets for securities related to small-business loans and commercial mortgages.[2] The Riegle Act extended regulatory accommodations similar to those available under SMMEA. These reforms included amendments to the federal banking laws to allow national banks, federal savings and loan associations, savings banks, and credit unions to invest more easily in these securities; preemption of state registration requirements and investment restrictions; and modifications to the federal securities laws to accommodate settlement and delivery practices. The Riegle Act also made participation of depository institutions in small-business-loan securitizations easier by instructing federal bank regulators to reduce risk-based capital requirements.

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1. Specifically, section 209 requires the agencies to address the impact of Subtitle A of Title II, dealing with the securitization of small-business-related loans, and sections 347 and 350 of Title III, dealing with the securitization of commercial mortgages. (See appendix A.)

2. See S. Rep. No. 103-169, 103rd Cong., 2nd Sess. 30-38 (1994); H.R. Conf. Rep. No. 103-438, 103rd Cong., 2nd Sess. 166-1967 (1994). Section 202 defines a "small business concern" as "a business that meets the criteria for a small business concern established by the Small Business Administration under section 3(a) of the Small Business Act."

The first report to the Congress, submitted in 1996 (1996 Report), provided a fairly extensive review of activity in the markets for securitization, the unique features of small business and commercial real estate loans, and the legal changes effected by the Riegle Act.[3] This second report focuses on changes that have taken place in the markets since 1996. Specifically, this section provides an overview of securitization activity and credit availability in the interim two years and presents the agencies' current views on the need for further administrative or legislative initiatives. Sections II and III update information on securitizations of commercial real estate and small business loans. Section IV updates information on previously cited securitization impediments and discusses an accounting issue that has implications for the treatment of asset sales by banks.

A. Securitization Activity and Credit Availability

Securitization has proceeded apace in those markets for which the costs of information about loans and borrowers are low. In particular, loans that fit standardized underwriting criteria and for which there is enough history on comparable loans to estimate default probabilities and prepayment patterns are popular candidates for securitization. Commercial real estate loans generally satisfy these criteria, and securitization of commercial real estate loans has accelerated in recent years. Securitization of small business loans, in contrast, has been much slower to get under way owing to the particular and diverse characteristics of these loans. But lenders are gathering historical information on return and default characteristics of large portfolios of small business loans that could provide the basis for better risk assessment and standardization down the road. Although few small business loans have been securitized to date, creditworthy small businesses appear to have had good access to credit from banks and other lenders in the past two years.

Commercial Real Estate Markets. The volume of commercial mortgages in securitized pools expanded about 35 percent per year between 1993 and 1997 and nearly doubled in the year ending June 1998. The growth of total commercial mortgage debt has

3. The reader is referred to the earlier report for a discussion of the Riegle Act's provisions that were intended to remove regulatory obstacles to the securitization of loans to small business and mortgages on commercial real estate.

been more modest than suggested by the brisk pace of securitizations, as mortgage pools have, in part, replaced declining shares of commercial mortgage loans at thrift institutions and life insurance companies. Even so, total nonfarm, nonresidential mortgage debt has expanded nearly 8 percent at an annual rate over the past two years, more than reversing the contraction that occurred in the last recession. As a result, outstanding commercial mortgage debt has moved somewhat above its peak in 1990.

Both demand and supply factors have contributed to the turnaround in commercial mortgage lending generally. Activity in the commercial real estate market has been picking up. Vacancy rates, especially for office buildings, have declined, and price indexes for an array of commercial properties have been on the upswing, providing evidence that conditions in these markets have improved significantly since the contraction.[4] Federal Reserve surveys of commercial banks indicate that demand for commercial real estate loans has been strong in recent quarters, and bank examiners surveyed by the Federal Deposit Insurance Corporation (FDIC) have reported a general firming in commercial real estate markets nationwide since 1996.[5]

Credit to finance multifamily housing, office buildings, and other commercial properties seems generally to have been readily available. The bulk of such credit continues to come in the form of bank loans. Banks have reported some modest relaxation of lending standards since 1996, according to survey evidence, but the easing likely reverses only a small part of the tightening that occurred following the real estate market correction of the late 1980s. Terms on bank loans, however, have eased more noticeably. The spread between Treasury yields and yields on commercial mortgages--which reflects the premium that lenders require to cover credit risk and uncertainty of mortgage prepayments--trended down in 1996 and 1997 to very low levels. The spread has reversed some of this decline in 1998, as prospects for slower economic growth and fewer profitable opportunities for commercial

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4. For example, according to the National Real Estate Index (NREI), prices in 1997 increased about 13 percent for office properties, 10 percent for multifamily properties, and 8 percent for retail properties.

5. FDIC, *Survey of Real Estate Trends, An Assessment by Senior Examiners and Asset Managers at Federal Bank and Thrift Regulatory Agencies* (quarterly) and Federal Reserve Board, *Senior Loan Officer Opinion Survey on Bank Lending Practices* (quarterly).

property investment perhaps have heightened lender caution.

Securitization of commercial mortgage loans has increased liquidity for lenders, contributing to low costs of financing transactions in these markets. However, its rapid growth has raised some concerns about the ability of investors and rating agencies to stay ahead of the market and to accurately assess the credit risks of loans underlying the securities. This concern is heightened by speculation about possible overheating in commercial real estate markets generally, which historically have been subject to sizable cyclical swings. Although no substantial problems have surfaced thus far, bank regulators recently cautioned banks and other lenders to carefully examine risk exposures in commercial lending areas that have been growing rapidly.[6]

The loans that institutions have made in the last few years to finance commercial real estate investments have been mostly trouble free. Delinquency rates on the outstanding stock of commercial real estate loans have dropped steadily, to near 2 percent at banks and less than 1 percent at life insurance companies in the first quarter of 1998. Similarly, charge-off rates on such loans at banks have been very low. But regulators and others have been quick to point out that the solid economic growth and low inflation of recent years have produced a favorable environment for businesses and households, and the true test of the risk of current credit extensions will be further down the road. The widening in 1998 of spreads on mortgage loans and on commercial-mortgage-backed securities (CMBS) likely reflects some concerns among institutional lenders and investors about the continuation of strong growth, especially in light of turmoil in Asian markets.[7]

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6. Expressions of concern that commercial lending standards may have deteriorated led Federal Reserve staff to undertake an extensive review of lending standards and actual loans being made at a sample of large banking institutions in the second half of 1997. Based on this review, the staff highlighted several areas for increased supervisory attention, one of which was lending to real estate investment trusts (REITs). Supervisors were advised that loans to REITs remain fundamentally a form of real estate exposure and that lenders should assess the ability of REIT borrowers to maintain their financial strength and liquidity in the event of a widespread downturn in commercial property markets. (Letter, dated June 23, 1998, to supervisory staff at the Federal Reserve Banks on Lending Standards for Commercial Loans from the Federal Reserve Board Division of Supervision and Regulation).

7. Some of the rise in commercial mortgage rate spreads may be due less to rising concerns about risk in mortgage markets and more to declines in Treasury yields, as many investors looked to U.S. government securities as safe harbors following developments in Asia.

As the market for CMBS has grown, so has the size of the loans that back these securities. Few commercial mortgages of less than a $1 million have found their way into mortgage pools. Small nonresidential real estate loans are similar to other small commercial loans; they require closer assessment and monitoring of the borrowing firm and its operations, and their credit quality may depend more on the financial backing of the owner.

Small Business Loan Markets. Estimates suggest that between $2.5 billion and $3 billion of non-SBA-guaranteed small business loans have been securitized to date, of which less than a billion have been marketed in the last two years. Securitization has been slow primarily because it takes time to build the information bases needed to assess the risks of small business loans and to determine standard criteria for assessing risk. The growing use of credit-scoring models holds promise for facilitating the securitization of small business loans; in particular, credit scoring generates pools of small business loans that have been evaluated based on common criteria.[8] Surveys of banks indicate that the use of credit-scoring models has become increasingly common in the loan approval process although scored small business loans have mostly been held by banks and not yet securitized.

Even without an active market for securitized loans, small business lending has grown briskly in the last few years.[9] Between June 1996 and June 1998, the dollar volume of small business loans (defined as loans of less than $1 million) expanded at a 5-1/2 percent annual rate at all commercial banks. About 20 percent of this growth was in loans of less than $100,000. Large commercial banks continued to ease, on net, standards for approving loans to small firms in 1997 and the first half of 1998, according to Federal Reserve surveys. Many large banks have initiated programs aimed at attracting small business customers. The reports of lenders seem to be confirmed by evidence gathered from

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8. Credit scoring is an automated process by which information about an applicant is used to predict that applicant's likelihood of repaying a loan. The relationships between characteristics of the borrower and loan performance are estimated using historical data on the performance of past borrowers. Such models have been reliable to date, according to reported studies, but they have not been tested in a period of economic stress. Most view these models as a tool for lenders in evaluating risks, but one to be used cautiously until honed and tested over a range of economic conditions and borrowers.

9. See Board of Governors of the Federal Reserve System, *Report to the Congress on the Availability of Credit to Small Businesses,* October 1997, for a detailed assessment of small business credit through 1997.

small business borrowers. Small and medium-sized firms surveyed by the National Federation of Independent Business generally have been optimistic in their outlook for the economy and their firms' growth prospects.[10] The net percentage reporting that credit is hard to obtain has been very low, and "credit availability" ranks well down on the list of their most pressing concerns.

The willingness of banks to hold small business loans on their books has been cited by some as one reason that securitization of such loans has not picked up more than it has. Delinquency rates on business loans have been low, and banks seem to have ample liquidity, suggesting that they have little need to push for securitization in the current environment. Nonetheless, banks have been active securitizers of real estate and consumer loans, and they will probably become more active securitizers of small business loans as the market matures and credit evaluation techniques are validated over more varied economic conditions.

B. Recommendations

In assessing the securitization activity in the markets for commercial real estate and small business loans, the agencies have sought to identify factors that might inappropriately impede the development of either market. The 1996 Report noted several regulatory or legislative obstacles that market participants had cited as lingering problems. Since that time, actions have been taken in each of these areas (see section IV). The results of these actions, or the market's ability to maneuver around obstacles, appear to have diminished the problems. Although no significant issues requiring legislative action have surfaced in the subsequent period, a conflict between accounting standards concerning loan sales and the regulatory powers of the FDIC has led to uncertainty about the ability of banks subject to FDIC oversight to use loan sale accounting.[11] Efforts currently are under way by staff of the Financial Accounting Standards Board (FASB) and the FDIC to clarify and, if possible, to reduce this uncertainty.

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10. National Federation of Independent Business, *Small Business Economic Trends*, monthly surveys of small and independent business owners.

11. This issue is discussed in section IV-D.

The agencies note that, while the securitization of commercial real estate loans has developed rapidly, the market for small business loan pools is still in its infancy, and it would be premature to rule out the possibility that hindrances will develop down the road. Thus, the agencies will continue to monitor the developments and will make recommendations as appropriate in the future.[12]

Section 209 of the Riegle Act directs the agencies to consider the need for implementing a system of reports to better monitor these markets. The banking agencies have begun requiring depository institutions to report the number and the amount of small business loans sold with recourse (such loans qualify under the Riegle Act for special capital treatment when securitized). Information on rated securities backed by small business loans has been available from the credit-rating agencies. The volumes to date have been too small to warrant collecting information from purchasers of small-business-related securities. The agencies have obtained some information on commercial-mortgage-related securities from market sources. However, the information is still piecemeal and not completely pertinent to the issues raised in section 209 of the Riegle Act. Thus, although the agencies currently do not feel there is a need to impose formal reporting requirements on securitizers or purchasers of these securities, they are continuing to investigate the availability of more information on these markets. If it becomes clear that available sources are inadequate and that the benefits from additional collection efforts outweigh the costs, the agencies will make appropriate recommendations for new reporting mechanisms in the next report.

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12. Several market participants who are working to pool small business loans for securitization confirm that the problems they face are market driven rather than regulatory in nature.

II. The Market for Securitized Commercial Mortgages

Over the past two years, the market for commercial-mortgage-backed securities (CMBS) has expanded substantially. Gross issuance of CMBS, which was nearly $30 billion in 1996, grew to almost $44 billion in 1997. The pace of issuance in the first half of 1998 was even faster, suggesting that gross issuance for the year will surpass $80 billion. The rapid growth of the CMBS market represents largely a maturing of the market; it has been accompanied by the emergence of larger deals, the increased importance of loans originated specifically for securitization, and the movement toward Wall Street conduits as the major source of issuance. At the end of the second quarter of 1998, CMBS outstanding stood at $210 billion, including $170 billion securitized by private issuers and $40 billion securitized by government-sponsored enterprises (GSEs) (exhibit 1). Although this share is only 17 percent of the total commercial mortgage credit outstanding of $1.2 trillion, it is up substantially from 9 percent at the end of 1995 (exhibits 2 and 3). At present, CMBS are the largest source of mortgage financing for multifamily properties and represent 15 percent of nonresidential mortgage debt. Some important developments in the market are summarized below.

A. Recent Market Developments

Growing importance of public capital markets. Traditionally, the commercial real estate market has been characterized by private ownership financed by intermediaries, such as banks, thrifts, and insurance companies. Individuals and private companies still own most commercial properties, and intermediaries still hold the bulk of outstanding debt, but most of the new money flowing into commercial real estate has come from public capital market sources. Besides the increased provision of financing through CMBS, a substantial amount of property has been acquired by public real estate investment trusts (REITs). Since 1989, financial intermediaries as a group have reduced their direct holdings of commercial real estate debt by $35 billion, whereas outstanding debt either backing CMBS or held by REITs has increased $184 billion (exhibit 1). In addition, REITs have issued $98 billion in equity to finance the acquisition of property. CMBS have been issued increasingly in the public rather than in the private markets. More than 70 percent of issuance has been public in 1998,

versus less than 50 percent in 1996 (exhibit 4, top panel).

Growing importance of loans originated for securitization. As the CMBS market has matured, a growing proportion of the mortgages backing the securities has been originated specifically for securitization. The early CMBS market was dominated by Resolution Trust Corporation (RTC) issuance backed by performing and nonperforming real estate loans from failed thrift institutions and issuance by banks and insurance companies looking to restructure their balance sheets. As late as 1991, 98 percent of the collateral backing CMBS was seasoned loans. As traditional lenders withdrew from the commercial mortgage market in the early 1990s, however, loans originated for securitization began to represent a larger proportion of collateral. This trend has continued: Such loans represented more than 90 percent of securitized mortgages in the first quarter of 1998, up from 66 percent in 1996 (exhibit 4, middle panel).

Growing importance of Wall Street conduits. Over the past two years, securitization programs set up by Wall Street conduits have come to dominate the issuance of CMBS. Whereas they represented only 16 percent of the issuance in 1994, they accounted for 60 percent of issuance in 1997, and almost 90 percent in the first half of 1998 (exhibit 4, lower panel). Conduits are companies that facilitate the origination and securitization of mortgages; they usually rely on one or more correspondents, often banks, to originate the loans, and they provide the underwriting standards for the loans and issue the securities. Conduits such as Lehman Brothers, Morgan Stanley, and Nomura Securities are among the largest issuers of CMBS (exhibit 5). Most of the securitization programs set up by these conduits fall into four categories: "traditional conduits," which securitize a large number of small balance loans; "large loan programs," which securitize a small number of $50 million and larger mortgages; "fusion" deals, which combine small balance and large loans; and short-term floating rate loan programs. Traditional conduits and fusion deals together compose two-thirds of all securitizations thus far in 1998.[13]

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13. Source: *Commercial Mortgage Alert,* CMBS Data Base, June 30, 1998.

B. Characteristics of Commercial-Mortgage-Backed Securities

Deal size. The size of the average deal has increased substantially over the past few years, from $191 million in 1995 to $419 million in 1997 and to $724 million so far this year.[14] Before 1996, no domestic issues (excluding two RTC issues) exceeded $1 billion. In the first half of 1998, 18 of the 60 transactions were more than $1 billion. The largest transaction to date was a $3.7 billion issue by Nomura Securities in March 1998. Larger deals allow issuers to lower costs by spreading certain fixed costs over a greater volume of issuance. In addition, the greater liquidity of the bigger issues attracts investors who can hold larger positions in a security without adversely affecting trading.

Property types. As deals have increased in size, they have also become more diversified. In 1997, more than 75 percent of the deals contained more than one property type (in 1994, less than 45 percent did so). Over the past two years, properties backing new issues of CMBS were split about evenly among retail, office, multifamily, and all other types of properties (exhibit 6).

Geographic Distribution. Most deals are also geographically diversified. For example, in 1997, approximately 88 percent of the dollar volume of securitizations was backed by properties located in more than one state. As might be expected, many of the properties are located in California, New York, Texas, and Florida (exhibit 7).[15]

Ratings. Most home mortgages permit borrowers to prepay at any time without penalty, but most commercial mortgages are written to include one or more prepayment penalties. Therefore, unlike securities backed by residential mortgages, CMBS generally provide some protection from unscheduled prepayments. Although prepayment risk is thus smaller, credit risk is much greater. The greater credit risk is due both to a general belief that pools of commercial mortgages exhibit greater loss variance than do pools of single-family home loans and to the lack of federal guarantees for CMBS (except for securities issued by

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14. Source: *Commercial Mortgage Alert*, CMBS Data Base, June 30, 1998.

15. The data in exhibit 7 identify the proportion of each CMBS pool by state for those states that have more than 5 percent of the value of the pool. The location of properties in the balance of the pool remains unidentified. A typical multistate pool had properties in more than twenty states; however, only the three or four states with the highest proportion of the deal are identified. Over half the value of the multistate deals fell into the "unidentified" geographic category. Since the property share of the larger states is often identified, these states likely make up a smaller proportion of the unidentified part of the sample.

the GSEs that are backed by multifamily mortgage pools.)

The most common method of dealing with the credit risk is to create multiclass securities with junior, or subordinate, components. The junior securities have a right to principal payments only after the senior securities are paid in full. Because the junior securities absorb the first losses of the pool, up to their principal amount, they provide credit protection to the senior bond classes. The largest share of securities are senior, and these usually receive a triple-A or double-A rating (exhibit 8).[16] The junior securities receive lower ratings. Exhibit 9 shows the share of deals rated by each of the four major credit-rating firms. Since 1996, both Moody's and Standard & Poor's have increased the shares of the market that they rate, while Fitch has maintained a sizable share.

Pricing. Rates on commercial mortgages trended down appreciably through the end of 1997, with spreads relative to Treasury securities also dropping (exhibit 10). The narrower spread on mortgages reflected a decrease in the perceived risk in real estate lending due in part to the cyclical recovery in real estate. Issuers of securitized debt also reduced their cost of funds as the yield premium on CMBS relative to comparable Treasury securities declined (exhibit 11). This decline reflected not only the improved real estate market but also increased acceptance of CMBS as investors had become more familiar with the instruments.

While interest rates on ten year mortgages have remained low in 1998, the yield spreads on both commercial mortgages and CMBS have increased markedly in the first eight months of this year, with CMBS yield spreads in August rising to levels not seen since 1995. These increased spreads reflect increased concern about future developments in the real estate market and the recent heavy issuance of CMBS. However, some of the increased spread was caused by private debt markets not fully sharing in the investor flight to quality that lowered Treasury yields following developments in Asia since last fall.

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16. CMBS that received a AAA rating in the first quarter of 1998 had, on average, subordinated tranches equal to 31 percent of the underlying pool, with the lowest amount of subordination being 27 percent and the highest about 48 percent. Source: *Commercial Mortgage Alert.*

C. Primary Buyers of Commercial-Mortgage-Backed Securities

Although no detailed data are available on purchasers or holders of CMBS, discussions with market participants identified life insurance companies, investment advisers, and banks as the primary buyers of CMBS and REITs and hedge funds as other buyers.

As the real estate market has improved, life insurance companies have reentered the commercial mortgage market through both direct loans and CMBS. Discussions with market participants suggest that life insurance companies purchased about one-third of CMBS issued in 1997. Life insurance companies were attracted to CMBS partly because with their lower prepayment risk they tend to perform better than residential mortgage-backed securities in an environment of falling interest rates. Life insurance companies are also responding to risk-based capital incentives to hold investment-grade securities rather than loans.[17]

Another third of CMBS issuance in 1997 was sold to investment advisers. The high yield of securitized commercial mortgages attracted individual investors, as well as mutual funds and pension funds, interested in current income.

About 10 percent of CMBS issuance is estimated to have been purchased by banks. Other purchasers of CMBS in 1997 included hedge funds, REITs specializing in commercial mortgage assets, Federal Home Loan Banks, Freddie Mac, and Fannie Mae. In addition, REITs and other public real estate companies have often acted as special servicers in securitizations. Special servicers are employed by the sponsor of a CMBS to negotiate the workout of mortgages in the underlying pool that are either delinquent or in default. In many cases, the special servicer will also hold the most subordinate securities (that is, the first-loss position) of the issue, since the investment return on these securities depends most on the ability of the special servicer to cure delinquent loans and maximize the proceeds to the pool from those loans in default. For example, at the end of 1997, the largest commercial mortgage REIT, Criimi Mae, held more than $1.2 billion in subordinate CMBS.

D. Use of Commercial-Mortgage-Backed Securities by Small Businesses

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17. Appendix B discusses capital requirements for life insurance companies and commercial banks.

No data are directly available on the use of CMBS by small business, but looking at the average value of loans can provide some upper-bound estimate on the extent of use.[18] The average value of a loan backing CMBS is large--$5.3 million in 1997. In that same year, there were four issues totaling $600 million in which the average loan value was less than $1 million, with more than $200 million of the total backed by multifamily properties.[19] All four deals were composed of seasoned loans that were not originated for securitization. The average value of loans originated for securitization was $7 million in 1997. Data for other years are similar. Apparently, small businesses have not been large users of CMBS finance; however, several securitization programs have begun to target this market.

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18. The average value of the loan is not the amount provided to the borrower. It is calculated as the amount of funds raised in the CMBS issue divided by the number of loans in the pool. Since the issues are over-collateralized and some loans have already repaid part of the principal, it is an underestimate of average loan size at origination. Source: *Commercial Mortgage Alert.*

19. So far in 1998, only one domestic CMBS issue has had an average loan value of less than $1 million.

III. The Market for Securitized Small-Business Loans

The potential size of the market for securitized small business loans appears large when gauged by the amount of small business loans outstanding at all financial institutions. On June 30, 1998, commercial banks held roughly $370 billion in loans to businesses that originally were in amounts of less than $1 million per loan (exhibit 12). The volume of loans has expanded about 6 percent per year, on average, since 1994, though growth slowed in 1998. Data from the 1993 National Survey of Small Business Finance suggest that banks hold about 60 percent of the volume of small business loans at financial institutions. The remainder is held by finance companies and thrift institutions. Taken together, the data imply that more than $615 billion of small business loans are outstanding on the books of financial institutions. Clearly, not all of these loans could be securitized, but even part could provide the basis for a sizable market. To date, however, the volume of securitizations has been small, in part because it is taking time for lenders and investors to develop the extensive databases that will provide an efficient means for evaluating the credit risks associated with pools of heterogeneous small business loans and in part because banks apparently have preferred to hold such loans on their books in the current positive financial environment.

A. Recent Market Developments

Securitization Has Proceeded Slowly. Available data through the first half of 1998 indicate that twenty-nine rated issues totaling about $2.6 billion of securitized small-business loans have been offered either publicly or privately since such securities first were issued in 1992 (exhibit 13).[20] Only about $700 million have been marketed since 1996--a period during which other asset-backed securities have been growing rapidly. As was the case in the last report, securitization has been dominated by a few finance companies--The Money Store being the largest issuer.[21] Despite the easing of capital requirements on qualified small

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20. Almost all placements are evaluated by a rating agency. Nonetheless, some placements may have been missed. These data do not include securitizations of loans guaranteed under Small Business Administration (SBA) loan programs.

21. The Money Store recently was purchased by First Union Bank. This purchase could affect the volume of loans that are securitized, but First Union's decision to operate The Money Store for at least one year as a

business loan securitizations, banks have not been eager to sell such loans. Commercial banks are required to report the number and volume of loans sold with recourse that qualify for the special capital treatment prescribed in the Riegle Act.[22] As shown in exhibit 13, these amounts to date have been negligible, especially when compared with the volume of small business loans outstanding. Similarly, commercial banks that are required to report small business loans under the Community Reinvestment Act guidelines indicated that only about 1 percent of such loans in 1997 had been acquired through loan purchases.

Reasons for Slow Growth. Some observers have suggested that the current financial environment has not been especially conducive to securitization of small business loans. In particular, recent small business loans have been attractively priced assets with low delinquency rates that banks may prefer to hold on their books. In addition, however, the 1996 Report noted several natural impediments to securitization of small business loans that may take markets time to overcome. A stumbling block has been the lack of standardized lending terms and uniform underwriting guidelines for such loans, coupled with an inadequate amount of historical information on credit performance.

Since the last report, the volume of small business loans that can be readily securitized seems to be growing. In particular, the increasing use of credit-scoring models among the largest lenders may be generating a substantial portfolio of small business loans, all of which have been rated using similar scoring systems.[23] Moreover, in concert with this development, a number of banks with strong consumer credit card programs have begun promoting business credit cards, especially for their smaller business customers. The volume

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stand-alone subsidiary suggests that many of the The Money Store's operations will be carried out much as before.

22. When a bank sells loans with recourse, it assumes a first-loss position on some portion of the group of loans that were sold, enhancing the attractiveness of the pool to investors. Most securitizations, or sales of a security whose return depends on the performance of an underlying pool of loans, involve at least some credit enhancement via recourse.

23. The Fair-Isaacs system for scoring small business loans has been purchased by more than 250 large lenders. Although some of these banks have customized their scoring systems to their particular small business markets, Fair-Isaacs has imposed some degree of comparability of the scores across lenders. The use of scoring models reduces the cost of assessing the credit quality of small business loans. Indeed, interviews with a number of banks suggest that relying on scoring models may reduce processing costs from several thousand dollars for each loan to less than $100 per loan.

of small business loans at banks that specialize in credit card lending has doubled in the past two years although the level remains small ($2.7 billion as reported in June 1998 Call Reports). Many credit card issuers are accustomed to selling pools of consumer credit card debt to investors, and it appears likely that, as the business programs grow, these banks will also securitize business card receivables. At the same time, however, lenders are aware that credit-scoring models have yet to be rigorously tested by the market. In particular, they have monitored the performance of small business loans only for the past several years, and they have no data on loan performance during an economic downturn.

B. Characteristics of Recent Securitizations

Loans backing recent securitizations have, in all but one case, been the *unguaranteed* portion of loans made under the SBA's 7a program (exhibit 14). Securitization of the *guaranteed* portions of SBA loans has been sizable for a number of years. About 40 percent of such loans have been securitized since 1993 (exhibit 15). In contrast, only about 10 percent of the unguaranteed portions have been securitized, and there have been few identifiable securitizations of small business loans that are not made under an SBA program.

Almost all securitizations of the unguaranteed part of SBA loans involve loans that are backed by real estate, and some carry additional types of security, such as liens on equipment, claims on accounts receivable, and personal guarantees. The average maturity of the loans in the pool is fairly long--15 to 20 years is typical. The real estate backing, maturity, and other standard guidelines required for loans to receive SBA approval are characteristics that may make such loans easier to securitize.

The Money Store, which has been the most active securitizer of guaranteed SBA loans, also has taken the lead in securitizing the unguaranteed portion of these loans. Issues marketed by the Money Store in the past year or so have had somewhat less credit enhancement than earlier issues. For example, the typical Money Store offering carried a 7 percent subordination and a 3-1/2 percent spread account as credit enhancements, compared with about a 9 percent subordination and a 4 percent spread account on securitizations in

1993 and 1994.[24] Other less-frequent issuers seem to retain a larger subordinated piece of their issues.

C. Recent SBA Regulatory Changes

In April 1997, the SBA issued an interim regulation that affected the market for the unguaranteed portion of SBA loans by allowing banks to securitize the unguaranteed portion of SBA loans, whereas previously only nonbanks had this capability.[25] Both banks and nonbanks were required to get case-by-case approval of securitizations, and the main determinant was whether the issuer retained an interest in the pool of loans. The SBA subsequently modified the interim regulation and submitted for final comment a proposal that would require securitizers to hold the greater of 2 percent of the unguaranteed portion of loans or two times the loss rate on SBA loans of the lender who was securitizing the pool.[26] SBA analysts assert that this requirement should not materially alter the rate of securitization because most of the issuers in recent years have retained a subordinated part of the package of roughly 5 percent to 10 percent.

D. Community Development Loans

Many community development loans finance affordable multifamily housing, and some fund small businesses in low- and moderate-income areas. Several nonprofit organizations have arranged warehousing systems that allow them to purchase and pool community development loans. The securitization of community development loans has been slow because of very low or even negative spreads that arise from the concessionary rates that often are offered on community development loans and because of the difficulty of evaluating risks of these loans, few of which carry credit scores. Nevertheless, at least one group, the

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24. The amount of subordination refers to the portion of a pool of loans that is first to absorb any shortage in the cumulative repayments on loans in the pool. The larger the percentage of subordination, the lower the probability of loss to investors on the remainder of the pool, other things being the same. "Spread accounts" are escrow accounts set up to absorb losses on the pool of loans. The difference between the net yield on loans and the interest payments to security holders is placed in a spread account until an amount has accumulated equal to a prespecified percentage of the loan pool.

25. See "Rules and Regulations," *Federal Register*, vol. 62, no. 63, April 2, 1997, p. 15601.

26. See "Proposed Rules," *Federal Register*, vol. 63, no. 95, May 18,1998, p. 27219.

Community Reinvestment Fund, has managed to securitize, in a number of small private issues, roughly $35 million of small business and affordable housing loans over the past decade. Because of the nature of their nonprofit charters, pool participants are not allowed to purchase loans from a bank unless that bank agrees to channel all of the proceeds of the loan sale back into new development loans. As a result, most of the volume of securitizations of community development loans has come from state and local development corporations and small business investment corporations.

IV. Regulatory and Structural Changes since the 1996 Report

The 1996 Report discussed three regulatory issues that a number of market participants had cited as continuing impediments to the securitization process. These issues included (1) the need for a more efficient trust entity for securitizing nonresidential mortgage assets; (2) the limitation on investments in small-business- and commercial-mortgage-related securities by employee benefit plans; and (3) proposals by the Comptroller of the Currency to limit bank investments in commercial-mortgage-related securities. Subsequent legislative and regulatory actions, discussed below, have helped alleviate these impediments. Not one of these issues has been cited as a major problem in recent discussions with market participants. However, a new issue, discussed below, has arisen; it concerns the interpretation of FASB Statement 125 with regard to asset "sales" by banks when the FDIC, acting as receiver for a failed U.S. bank, has authority to reclaim transferred assets. To qualify for special risk-based capital treatment under section 208 of the Riegle Act, the transfer of a small business loans must be treated as a loan sale under FASB 125.[27]

A. Trust Entities for Securitization

The 1996 Report noted market participants' desire for a more-efficient trust entity for securitizing nonresidential mortgage assets. The 1996 Report also noted that the Congress responded in August 1996 by authorizing a new tax vehicle called a Financial Asset Securitization Trust, or FASIT. The FASIT statutory provisions were made effective as of September 1, 1997, but the Treasury Department has not yet adopted appropriate regulations for FASITs. Apparently, only three FASIT transactions have taken place to date; two involved CMBS, and one involved residential mortgages.[28] Industry sources indicate that FASITs have been little used largely because of uncertainty resulting from the lack of explicit

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27. See appendix B.

28. See "REITs Favor FASITS," *American Banker-Bond Buyer,* vol 13, no. 28, p.1 (1998); Terry Peters, "First Commercial FASIT Priced," *National Mortgage News*, February 2, 1998; "Who's Who in Real Estate Financing," *Investment Dealers' Digest*, December 1, 1997, p.32.

Treasury Department regulations.[29]

B. Investment Limitations on Employee Benefit Plans

The Employment Retirement Income Security Act (ERISA) prohibits transactions between private pension funds and many other market participants known as "parties in interest." Some market participants believe this limitation is so encompassing that it severely restricts the types of securitizations private pension funds can purchase and inhibits the growth of some securities markets. This limitation makes structuring eligible transactions and performing the necessary due diligence to avoid or clarify conflicts with potential parties in interest very complicated and costly for securities issuers.

In response, the Department of Labor (DOL) created an exemption from the ERISA restrictions for certain residential-mortgage securities, reflecting in part the relatively low credit risk of most types of home mortgages when compared with other kinds of loans. The exemption also recognizes the extensive amount of historical credit performance information for home mortgages that is readily available to issuers, rating firms, and investors.

Prior to the 1996 Report, the Capital Consortium, which includes the National Realty Committee, the Mortgage Bankers Association of America, and the National Association of Realtors, submitted a proposal to the DOL seeking a class exemption for purchasers of investment grade CMBS. The DOL stated that it issued a tentative denial of this request on March 13, 1998 and that the Capital Consortium withdrew the request on May 22, 1998. In 1997, however, the DOL did expand previously granted exemptions. The expansion, among other things, provided more investment flexibility concerning FASITS and trusts with commonly occurring pre-funding accounts.[30]

C. Regulations from the Comptroller of the Currency

By extending to small-business- and commercial-mortgage-related securities some of the same benefits previously granted to residential-mortgage-backed securities, the Riegle Act

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29. See "Real Estate, Bank Associations Press for FASITs Rules," *BondWeek,* vol. 1825, no. 6 (1998).

30. See "Prohibited Transaction Class Exemption 97-34," *Federal Register*, vol. 62, no.139, July 21, 1997, p. 39021.

removed quantitative limitations on investments in these securities by national banks, subject to regulations prescribed by the Office of the Comptroller of the Currency (OCC). Section 347 of the Riegle Act provided the OCC authority to prescribe regulations governing bank investment practices with respect to these securities to ensure that acquisitions of such securities are conducted in a manner consistent with safe and sound banking practices.

To implement section 347, the OCC published, in December 1995, proposed rules that would revise standards for securities investment activities by national banks.[31] Comments were received on the proposals and a final rule went into effect in December 1996.[32] The final rule prescribes limitations on dealing in, underwriting, purchasing, and selling each of five defined types of securities, of which Type IV comprises small-business-, commercial-mortgage-, and residential-mortgage-related securities that generally are rated at least investment grade by a nationally recognized rating agency.

To address concerns about concentrated credit risk, the OCC initially proposed, for public comment, a diversification test for Type IV securities, which would have limited the proportion of any one borrower's collateral in a single security pool. However, most comments were against the proposed diversification requirement for several reasons.[33] The OCC did not adopt the collateral concentration limitation, stating that the statutory requirements set forth by the Riegle Act to have a credit rating assigned to the security by a nationally recognized statistical rating organization provided a sufficient safeguard against investment risk.

D. FASB Statement No. 125 and Receivership Powers of the FDIC

In order for the transfer of a loan or other financial asset to qualify as a sale, FASB 125 requires that the transferred loan be "isolated from the transferor--put presumptively beyond the reach of the transferor and its creditors, even in bankruptcy or other receivership." Some confusion, however, has arisen about the treatment of loans transferred by a U.S. bank that subsequently fails and is placed in receivership by the FDIC. When it first looked at this

31. See "Proposed Rules," *Federal Register*, vol. 60, no. 245, December 21,1995, p. 66152.

32. See "Final Rules," *Federal Register*, vol. 61, no. 232, December 2, 1996, p. 63972.

33. Ibid., p. 63975.

question, the FASB understood that the FDIC might reclaim a loan asset *but only* if it repaid *the principal and interest earned to the date of payment* to the investor--in essence making the investor whole. Under these conditions, the FASB concluded that the FDIC powers did not preclude a bank loan from being treated as a sale under FASB 125.

The FASB staff in late 1997 learned that the FDIC's powers are somewhat broader and do not require the full payment of interest earned *to the date of payment.* Rather, the FDIC is required to pay interest earned only *to the date of receivership,* which may be a shorter period by as much as 180 days than the date of payment. In that event, the investors might not be made whole.[34] In August, the FASB proposed revising the language in FASB 125 to state: "The ability of a receiver to reclaim transferred assets by paying anything less than principal and interest to date of payment (for example, principal and interest to date of receivership) would preclude sale accounting." This approach could preclude sale accounting for many transfers as currently structured by financial institutions subject to FDIC oversight.

At this time, it is not clear how this question will be resolved. However, staff of both the FDIC and the FASB are studying various options and expect to clarify the accounting and legal issues probably before year-end.

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34. In fact, the FDIC most often pays interest earned to date of payment unless the assets have been conveyed in a fraudulent manner or to an affiliate under improper circumstances.

APPENDIX A
SECTION 209 OF THE RIEGLE COMMUNITY DEVELOPMENT AND REGULATORY IMPROVEMENT ACT OF 1994

Joint Study on the Impact of Additional Securities Based on Pooled Obligations
(a)**Joint study required**. The Board and the Commission shall conduct a joint study of the impact of the provisions of this subtitle (including the amendments made by this subtitle) on the credit and securities markets. Such study shall evaluate--

(1) the impact of the provisions of this subtitle on the availability of credit for business and commercial enterprises in general, and the availability of credit in particular for--

(A) businesses in low- and moderate-income areas;
(B) businesses owned by women and minorities;
(C) community development efforts;
(D) community development financial institutions;
(E) businesses in different geographical regions; and
(F) a diversity of types of businesses;

(2) the structure and operation of the markets that develop for small business related securities and commercial mortgage related securities, including the types of entities (such as pension funds and insurance companies) that are significant purchasers of such securities, the extent to which such entities are sophisticated investors, the use of credit enhancements in obtaining investment-grade ratings, any conflicts of interest that arise in such markets, and any adverse effects of such markets on commercial real estate ventures, pension funds, or pension fund beneficiaries;

(3) the extent to which the provisions of this subtitle with regard to margin requirements, the number of eligible investment rating categories, preemption of State law, and the treatment of such securities as government securities for the purpose of State investment limitations, affect the structure and operation of such markets; and

(4) in view of the findings made pursuant to paragraphs (2) and (3), any additional suitability or disclosure requirements or other investor protections that should be required.

(b) **Reports**.

(1) In General. The Board and the Commission shall submit to the Congress a report on the results of the study required by subsection (a) before the end of--

(A) the 2-year period beginning on the date of enactment of this Act;
(B) the 4-year period beginning on such date of enactment; and
(C) the 6-year period beginning on such date of enactment.

(2) Contents Of Report. Each report required under paragraph (1) shall contain or be accompanied by such recommendations for administrative or legislative action as the Board and the Commission consider appropriate and may include recommendations regarding the need to develop a system for reporting additional information concerning investments by the entities described in subsection (a)(2).

(c) **Definitions**. As used in this section--

(1) the term “Board” means the Board of Governors of the Federal Reserve System: and

(2) the term “Commission” means the Securities and Exchange Commission.

APPENDIX B
RISK-BASED CAPITAL REQUIREMENTS[35]

Commercial-Mortgage-Related Securities. For some lenders and investors, risk-based capital requirements favor the holding of investment-grade securities rather than whole loans. For thrift institutions, securities that qualify under SMMEA are eligible for a 20 percent risk weighting instead of 100 percent, a weighting that reduces the capital charge on these securities to 1.6 percentage points from 8 percentage points. Life insurance companies have also been given a capital incentive to hold mortgages as investment-grade securities rather than as whole loans. Risk-based capital guidelines established by the National Association of Insurance Commissioners set the capital charge for commercial real estate loans between 1.5 percentage points and 9 percentage points--depending on the individual insurance company's historical mortgage delinquency experience--but only between 0.3 percentage point and 1 percentage point for investment-grade securities, including securitized commercial mortgages. Thus, some life insurance companies may choose to originate commercial mortgages, pool these loans for securitization, and retain only those classes of securities that incur the lower capital charges.

For banks, capital charges currently are not reduced when commercial mortgages (and most other assets) are held in the form of securities rather than as whole loans. Under existing risk-based capital standards, both commercial mortgages and CMBS are generally assigned to the 100 percent risk-weight category, resulting in a capital charge of 8 percent of the face amount of the asset on the bank's balance sheet.[36] However, section 350 of the Riegle Act required bank regulators to limit the amount of risk-based capital an insured depository institution is required to hold for assets transferred with recourse, including commercial mortgages. In particular, the amount of risk-based capital required to be maintained by any insured depository institution with respect to assets sold with recourse may not exceed the maximum amount of recourse for which the institution is contractually liable under the recourse agreement. This provision corrected an anomaly that existed in the risk-based capital treatment of recourse transactions under which an institution could be required to hold capital in excess of the maximum amount of loss possible under the contractual terms of the recourse obligation.[37]

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35. This appendix is taken from the 1996 Report with appropriate updates.

36. In August 1996, the Federal Reserve Board implemented an amendment to its risk-based capital guidelines for state member banks and bank holding companies that incorporates a measure for market risk and requires banks with significant trading activity to hold capital to support the "general market risk" and "specific risk" associated with its debt and equity positions in the trading account. Institutions covered by the new rule were required to comply no later than January 1, 1998. Debt and equity positions included in the market risk measure would be excluded from the credit risk capital requirements. Capital charges for specific risk are based on the identity of the obligor and, in the case of corporate securities, on the credit rating and remaining maturity of the instrument. Thus, banks affected by the rule have an opportunity to reduce their total capital requirements by holding highly rated securities rather than loans in their trading accounts.

In addition, banking agencies proposed reducing capital charges for triple-A-rated senior securities backed by any form of underlying asset, including small-business loans and commercial mortgages. See *Federal Register*, vol. 6, no. 214, November 5, 1997, p. 59944. Under current bank capital guidelines, mortgage-backed securities issued by Ginnie Mae are assigned a 0 percent risk weight, while those issued by Fannie Mae and Freddie Mac are assigned a 20 percent risk weight.

37. The Federal Reserve Board enacted regulatory amendments, effective March 22, 1995, to its capital adequacy guidelines for state member banks and bank holding companies that implement section 350 of the

For example, if a bank originates a $100 million pool of commercial mortgages, the capital charge would be $8 million. If the bank (acting as sponsor) securitizes the loans and retains a first-dollar loss position that provides credit enhancement to more senior securities, required capital equals the full capital charge against the underlying loans as if they had remained on the bank's balance sheet (again, 8 percent), subject to the limit that capital charges not exceed the bank's maximum credit exposure under the recourse agreement. Thus, if the bank retains a $5 million C-class security as recourse, the capital charge would be only $5 million.[38]

. **Small-Business-Related Securities**. To promote the securitization of small business loans by banks, the Riegle Act instructed federal bank regulators to amend risk-based capital requirements for qualifying insured depository institutions that transfer small business loans and leases on personal property with recourse. Section 208 of the Riegle Act states that such an institution shall include only the amount of retained recourse in its risk-weighted assets when calculating its capital ratios, provided two conditions are met. First, the transaction must be treated as a sale under generally accepted accounting principles (GAAP), and second, the depository institution must establish a noncapital reserve in an amount sufficient to meet the institution's reasonably estimated liability under the recourse arrangement. The aggregate amount of recourse retained in accordance with the provisions of the Riegle Act may not exceed 15 percent of an institution's total risk-based capital or a greater amount established by the appropriate federal banking agency.

A qualifying institution is defined as one that is *well capitalized* or, with the approval of the appropriate federal banking agency, *adequately capitalized,* as defined in the prompt corrective action statute. For purposes of determining whether an institution is qualifying, its capital ratios must be calculated without *regard* to the preferential capital treatment that section 208 sets forth for small-business obligations. The Riegle Act also states that the preferential capital treatment set forth in section 208 is not to be applied for purposes of determining an institution's status under the prompt corrective action statute (section 38 of the Federal Deposit Insurance Act). However, if an insured depository ceases to be a qualifying insured depository institution or exceeds the limits on its total outstanding amount of retained recourse noted above, the benefits of section 208 will remain applicable to any transfers of small-business loans or leases of personal property that occurred during the period when the institution was qualifying. [39]

Before this action, the entire amount of the assets sold with recourse had been included in the banking company's risk-weighted assets for calculating risk-based capital ratios. That is, banking organizations had been required to maintain capital against the full amount of assets transferred with recourse.

Riegle Act. (See *Federal Register*, vol. 60, no. 29, February 13,1995, p. 8177.)

38. In addition, if a bank currently purchases a junior security issued by another sponsor, that security is not considered a recourse obligation of the purchasing bank and generally is assigned a capital charge of 8 percent of its face amount. Thus, the effective capital charge on a $5 million nonrecourse junior position would be $400,000.

39. The Federal Reserve Board enacted regulatory amendments, effective September 1, 1995, to its capital adequacy guidelines for state member banks and bank holding companies that implement section 208 of the Riegle Act. (See *Federal Register*, vol. 60, no. 169, August 31, 1995, p. 45612.)

Exhibit 1

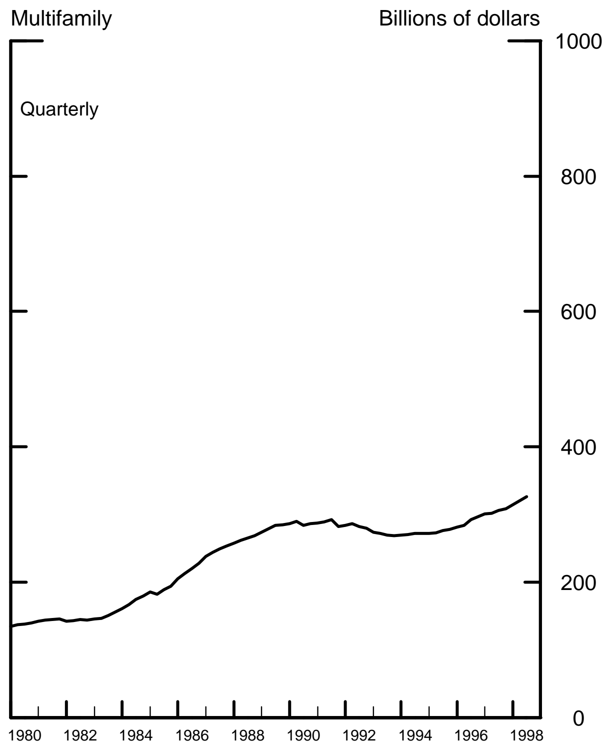
Sources of Commercial Real Estate Debt and Equity Financing
(Billions of dollars; end of period)

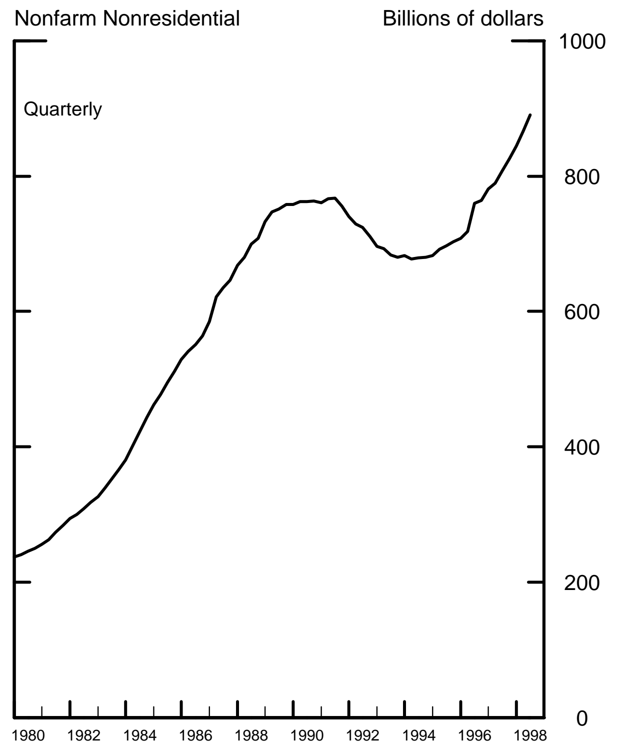
	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998[1]	Memo: Change 1989-98
Mortgage loans outstanding	**1,044.3**	**1,047.7**	**1,024.9**	**970.4**	**952.2**	**954.7**	**989.6**	**1,081.8**	**1,159.6**	**1,217.1**	**172.7**
Multifamily	286.4	286.9	284.1	274.0	269.8	271.8	281.8	300.7	314.6	326.5	40.1
Nonfarm, nonresidential	757.9	760.7	740.8	696.4	682.4	682.9	707.9	781.1	845.1	890.5	132.7
Loans held by:											
Financial intermediaries	**878.3**	**865.4**	**823.7**	**767.5**	**735.6**	**724.2**	**740.3**	**795.2**	**830.2**	**843.6**	**-34.7**
Commercial banks	362.6	374.1	377.2	369.9	366.2	374.3	396.9	422.0	454.6	467.5	104.9
Thrifts	240.9	201.0	166.6	138.0	128.1	118.3	114.1	114.3	110.8	109.2	-131.7
Life insurance companies	232.4	244.1	238.8	221.6	206.3	194.3	190.5	188.6	193.1	195.4	-36.9
Pension funds	29.7	32.0	27.4	24.4	22.3	25.4	26.6	28.2	30.3	31.5	1.8
Other[2]	12.8	14.2	13.7	13.6	12.7	12.0	12.1	42.1	41.4	39.9	27.1
Securitized	**38.6**	**41.9**	**42.9**	**52.5**	**64.3**	**83.7**	**105.8**	**139.7**	**180.8**	**222.9**	**184.2**
GSE mortgage pools[3]	25.7	28.7	26.1	23.8	22.5	22.4	26.9	32.5	37.8	40.4	14.7
Private mortgage pools	5.0	5.9	10.2	21.5	34.2	49.4	65.1	91.6	129.2	169.5	164.6
REITs	7.9	7.3	6.6	7.2	7.7	11.9	13.8	15.6	13.8	12.9	5.0
Other	**127.4**	**140.4**	**158.3**	**150.4**	**152.4**	**146.8**	**143.6**	**146.9**	**148.6**	**150.6**	**23.2**
State and local governments	46.1	47.8	49.3	49.9	50.5	51.8	51.9	53.5	54.1	54.3	8.2
U.S. government agencies	16.7	36.3	53.0	42.2	45.0	35.2	27.5	23.3	21.8	21.7	5.0
GSE portfolio holdings	12.0	13.2	14.2	15.8	17.5	18.4	19.0	18.6	17.3	16.7	4.7
Nonfinancial business	49.0	40.1	38.9	38.8	34.0	36.3	37.9	45.4	50.5	52.9	3.9
Nonprofit organizations	3.5	2.8	2.8	3.7	5.3	5.2	7.3	6.2	5.0	5.0	1.5
Memo:											
Cumulative REIT equity issuance	19.7	20.9	22.5	24.5	37.7	48.8	57.1	69.4	102.1	117.9	98.3

1. Data as of June 30, 1998.
2. Includes finance companies, mortgage companies, and other insurance companies.
3. GNMA, FNMA, FHLMC, and Farmers Home Administration pools.
Sources: Federal Reserve Board Flow of Funds Accounts, National Association of Real Estate Investment Trusts.

Exhibit 2

Commercial Mortgage Debt Outstanding

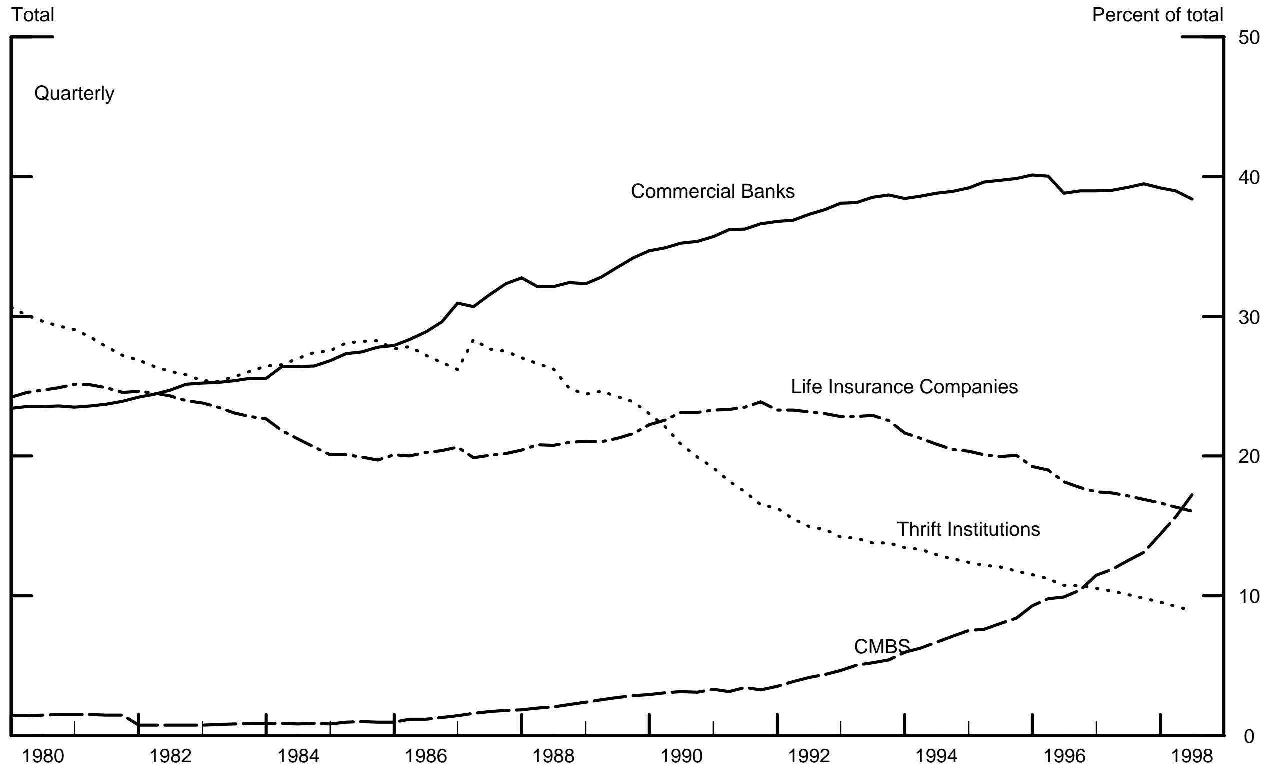


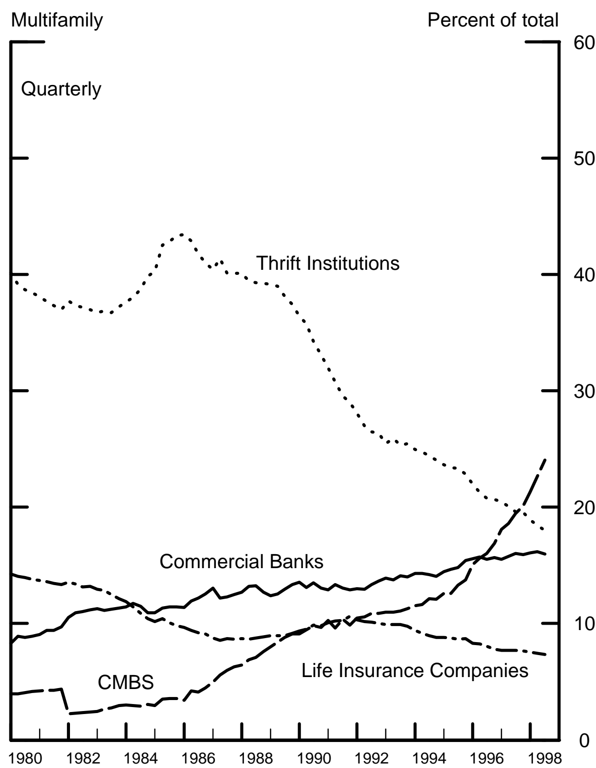


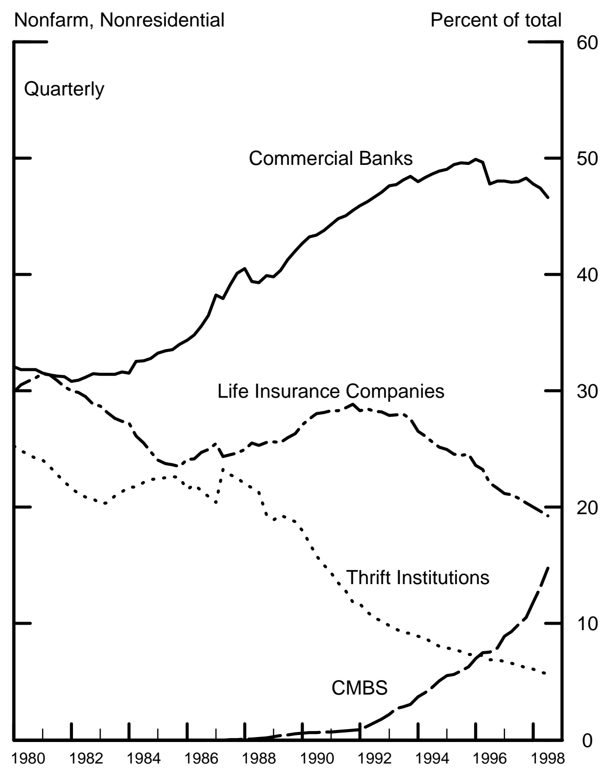
Source: Federal Reserve Board Flow of Funds Accounts.

Exhibit 3

Direct Holdings of Commercial Mortgage Loans, by Major Holder







Source: Federal Reserve Board Flow of Funds Accounts.

Exhibit 4

Gross Issuance of Commercial-Mortgage-Backed Securities, by Type of Offering, Loan Origination, and Seller/Borrower

	1994		1995		1996		1997		1998[1]	
	Billions of dollars	Percent of total	Billions of dollars	Percent of total	Billions of dollars	Percent of total	Billions of dollars	Percent of total	Billions of dollars	Percent of total
Type of offering										
Public	11.0	54	10.0	53	14.2	48	28.3	64	31.0	71
Domestic	8.1	40	9.0	48	13.3	45	24.8	56	30.5	70
International	2.8	14	1.1	6	.9	3	3.6	8	.5	1
Private	7.2	36	6.8	36	13.5	46	13.0	30	10.5	24
144A	5.9	29	6.0	32	13.3	45	12.6	29	10.3	24
Other	1.3	7	.9	5	.2	1	.5	1	.2	1
Fannie/Freddie	2.0	10	2.0	11	2.0	7	2.6	6	1.9	4
Total	20.2	100	18.9	100	29.7	100	44.0	100	43.4	100
Loan origination type										
For securitization	12.8	63	10.4	55	19.6	66	36.7	84	39.9	92
Other	7.4	37	8.5	45	10.1	34	7.2	16	3.5	8
Total	20.2	100	18.9	100	29.7	100	44.0	100	43.4	100
Type of seller/borrower										
Securitization program	3.3	16	5.9	31	12.2	41	26.4	60	38.3	88
Investment bank	.4	2	1.6	9	1.9	6	4.4	10	1.7	4
Developer	2.8	14	1.1	6	3.0	10	2.9	7	.8	2
Investment group	2.4	12	1.8	10	1.7	6	2.4	6	.4	1
Insurance company	.6	3	2.5	13	4.6	16	2.3	5	.0	0
Bank/thrift	3.3	16	.3	0	1.8	6	2.3	5	.8	2
REIT	2.5	12	1.7	9	1.4	5	1.7	4	1.3	3
Other[2]	5.0	25	4.0	21	3.2	11	1.6	4	.2	1
Total	20.2	100	18.9	100	29.7	100	44.0	100	43.4	100

1. Through June 1998.
2. Other includes pension funds, finance/mortgage companies, retailers, RTC/FDIC, and firms not classified.
Source: *Commercial Mortgage Alert.*

Exhibit 5

Gross Issuance of Commercial-Mortgage-Backed Securities, by Lead Manager

Lead manager (Ranked by dollar share in 1997)	1995			1996			1997			1998[1]		
	Millions of dollars	Number of deals	Dollar share (Percent)	Millions of dollars	Number of deals	Dollar share (Percent)	Millions of dollars	Number of deals	Dollar share (Percent)	Millions of dollars	Number of deals	Dollar share (Percent)
1. Lehman Brothers	2,964	15	15.7	5,784	16	19.5	8,467	11	19.2	7,348	8	16.9
2. Morgan Stanley	2,715	10	14.4	1,327	6	4.5	6,215	15	14.1	5,371	7	12.4
3. CS First Boston	2,331	12	12.3	776	4	2.6	4,222	6	9.6	4,839	3	11.1
4. Nomura Securities	1,823	4	9.6	3,331	4	11.2	3,689	3	8.4	6,107	3	14.1
5. Goldman Sachs	1,671	8	8.8	4,330	13	14.5	3,522	8	8.0	3,961	6	9.1
6. DLJ	1,312	6	6.9	2,695	10	9.1	3,050	8	6.9	3,608	5	8.3
7. Merrill Lynch	1,429	7	7.6	4,099	7	13.8	2,970	6	6.8	2,408	3	5.5
8. Deutsche Bank Securities	0	0	.0	173	2	.6	1,856	2	4.2	3,255	2	7.5
9. J.P. Morgan	723	3	3.8	983	3	3.3	1,644	3	3.7	936	2	2.2
10. Chase Securities	0	0	.0	0	0	.0	1,573	3	3.6	1,078	2	2.5
11. Citicorp Securities	663	4	3.5	656	3	2.2	1,292	3	2.9	1,505	2	3.5
12. NationsBanc Montgomery	381	5	2.0	1,383	8	4.7	1,079	3	2.5	1,295	3	3.0
13. UBS Securities	130	1	.7	399	2	1.3	756	7	1.7	0	0	.0
14. Smith Barney	110	2	.6	19	1	.1	382	2	.9	0	0	.0
15. Warburg Dillon Read[2]	261	6	1.4	271	10	.9	359	11	.8	250	11	.6
16. Bankers Trust	171	2	.9	600	5	2.0	202	1	.5	423	1	1.0
17. Other	2,216	14	11.7	2,868	17	9.7	2,723	13	6.2	1,047	2	2.4
18. Total	18,900	99	100.0	29,694	111	100.0	43,999	105	100.0	43,429	60	100.0

1. Through June 1998.
2. Dillon Read before 1997.
Source: *Commercial Mortgage Alert.*

Exhibit 6

Gross Issuance of Commercial-Mortgage-Backed Securities, by Property Type

Property type	1994		1995		1996		1997		1998[1]	
	Millions of dollars	Percent of total	Millions of dollars	Percent of total	Millions of dollars	Percent of total	Millions of dollars	Percent of total	Millions of dollars	Percent of total
1. Retail	5,681	28.1	4,778	25.3	8,167	27.5	12,218	27.8	12,084	27.8
2. Office	2,484	12.3	2,951	15.6	6,053	20.4	11,817	26.9	8,851	20.3
3. Multifamily	5,782	28.6	6,432	34.0	8,841	29.8	10,622	24.1	11,010	25.4
4. Hotel/resort	298	1.5	1,270	6.7	2,895	9.7	4,154	9.4	5,722	13.2
5. Warehouse/industrial	1,168	5.8	1,022	5.4	2,138	7.2	2,231	5.1	2,604	6.0
6. Nursing/retirement	445	2.2	752	4.0	609	2.1	1,761	4.0	1,337	3.1
7. Mobile home park	489	2.4	235	1.2	496	1.7	578	1.3	639	1.5
8. Other	3,877	19.2	1,461	7.7	496	1.7	618	1.4	1,182	2.7
9. Total	20,223	100.0	18,900	100.0	29,694	100.0	43,999	100.0	43,429	100.0

1. Through June 1998.
Source: *Commercial Mortgage Alert*.

Exhibit 7
Location of Mortgage Collateral for CMBS

(Millions of dollars)

Location	1996	1997	1998[1]
Identified[2]	16,518	20,350	11,085
California	3,482	6,949	6,999
New York	3,296	4,336	729
Texas	2,649	1,830	902
Florida	1,004	1,658	878
New Jersey	664	1,046	188
Massachusetts	600	798	187
Maryland	321	649	0
Virginia	378	472	339
Pennsylvania	321	355	438
Ohio	188	330	0
Minnesota	0	265	0
Illinois	884	246	0
Nevada	234	244	0
Georgia	624	224	61
Arizona	79	199	0
Michigan	444	192	57
District of Columbia	52	117	72
Guam and Puerto Rico	19	66	0
Indiana	68	60	27
Connecticut	95	54	0
New Hampshire	0	52	0
Oklahoma	39	48	13
Washington	44	47	0
Tennessee	58	35	26
Alabama	82	19	0
South Carolina	161	17	0
North Carolina	199	11	109
Arkansas	18	10	0
Kansas	0	10	0
New Mexico	52	8	5
Louisiana	153	3	26
Wisconsin	0	0	29
Idaho	161	0	0
South Dakota	81	0	0
Colorado	28	0	0
Montana	19	0	0
Kentucky	10	0	0
Vermont	6	0	0
Maine	5	0	0
Unidentified (multistate)	12,218	20,320	8,296
Foreign	958	3,329	170
Total	29,694	43,999	19,551

1. Through March 31, 1998.
2. Figures are compiled from data that indicate the proportions of the value of each CMBS deal that is represented by loans backed by collateral in a particular state. States with less than 5 percent of the value of a CMBS deal are in the unidentified category.

Source: *Commercial Mortgage Alert.*

Exhibit 8

Gross Issuance of Commercial-Mortgage-Backed Securities, by Rating Class

Rating class	1996		1997		1998[1]	
	Millions of dollars	Percent of total	Millions of dollars	Percent of total	Millions of dollars	Percent of total
Rated	**27,217**	**91.7**	**40,679**	**92.5**	**18,466**	**94.5**
AAA	13,720	46.2	24,173	54.9	12,067	61.7
AA	5,304	17.9	4,460	10.1	1,455	7.4
A	2,328	7.8	3,336	7.6	1,081	5.6
BBB	2,194	7.4	3,205	7.3	1,510	7.7
Below BBB	1,956	6.6	1,662	3.8	430	2.2
No rating given[2]	1,715	5.8	3,843	8.7	1,923	9.8
Unrated or unknown[3]	**2,477**	**8.3**	**3,320**	**7.5**	**1,085**	**5.5**
Total	**29,694**	**100.0**	**43,999**	**100.0**	**19,551**	**100.0**

1. Through March 1998.
2. Includes interest-only strips with and without rating and tranches with no rating.
3. Includes Fannie Mae and Freddie Mac securitizations, which carry an implied triple-A credit rating, plus lease-backed transactions, which carry the explicit credit ratings of tenants.

Source: *Commercial Mortgage Alert*.

Exhibit 9

Gross Issuance of Commercial-Mortgage-Backed Securities, by Credit Rating Firm

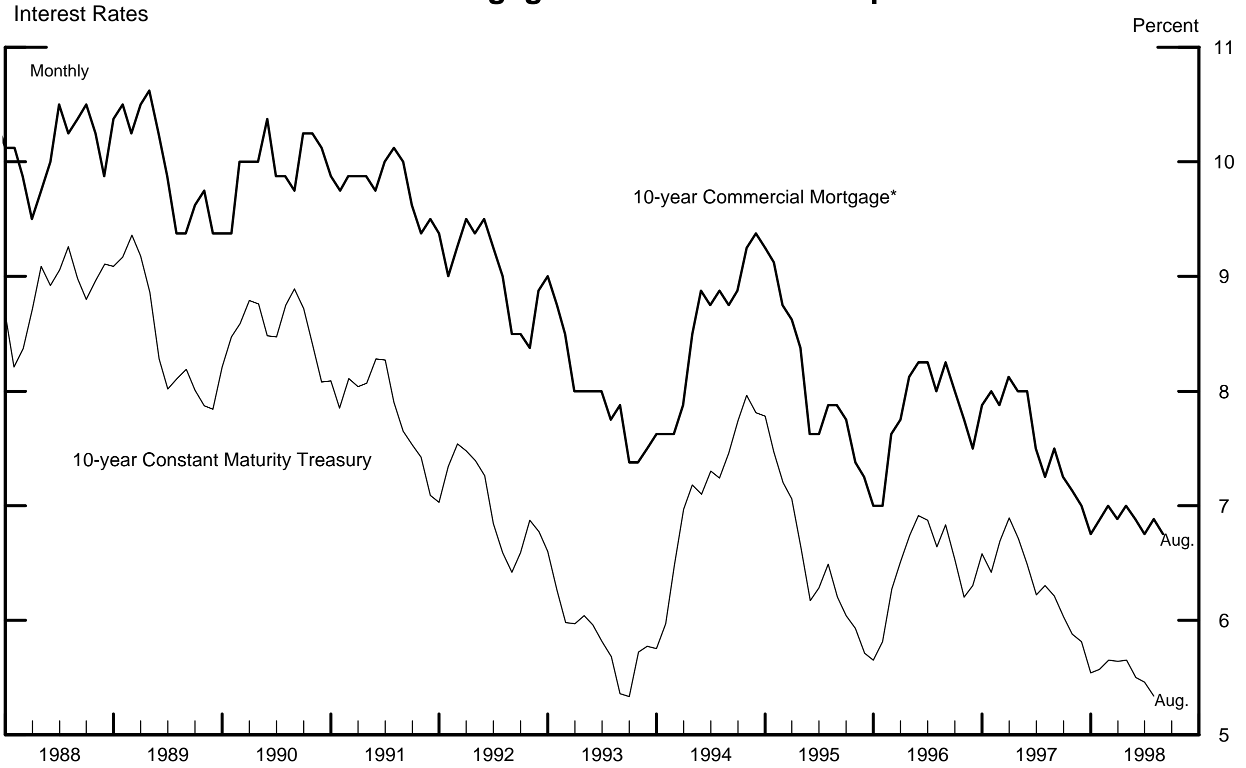
Credit-rating firm	1995			1996			1997			1998[1]		
	Millions of dollars	Number of deals	Dollar share (Percent)	Millions of dollars	Number of deals	Dollar share (Percent)	Millions of dollars	Number of deals	Dollar share (Percent)	Millions of dollars	Number of deals	Dollar share (Percent)
Rated[2]	**16,407**	**77**	**87**	**27,217**	**89**	**92**	**40,679**	**83**	**93**	**41,250**	**42**	**95**
Moody's	4,006	12	24	8,571	18	32	29,142	43	72	31,137	29	76
Standard & Poor's	10,188	47	62	17,477	51	64	26,192	43	64	27,707	27	67
Fitch	9,195	39	56	17,569	48	65	25,693	44	63	22,174	17	54
Duff & Phelps	6,978	24	43	11,243	29	41	14,465	26	36	11,710	9	28
Unrated or unknown[3]	**2,493**	**22**	**13**	**2,477**	**22**	**8**	**3,320**	**22**	**8**	**2,179**	**18**	**5**
Total	**18,900**	**99**	**100**	**29,694**	**111**	**100**	**43,999**	**105**	**100**	**43,429**	**60**	**100**

1. Through June 1998.
2. Details do not sum to total because individual deals may be rated by more than one credit-rating firm.
3. Includes Fannie Mae and Freddie Mac securitizations, which carry an implied triple-A credit rating, plus lease-backed transactions, which carry the explicit credit ratings of tenants.

Source: *Commercial Mortgage Alert*.

Exhibit 10

Commercial Mortgage Interest Rates and Spreads



*Source: Barron's/Levy National Mortgage Survey.

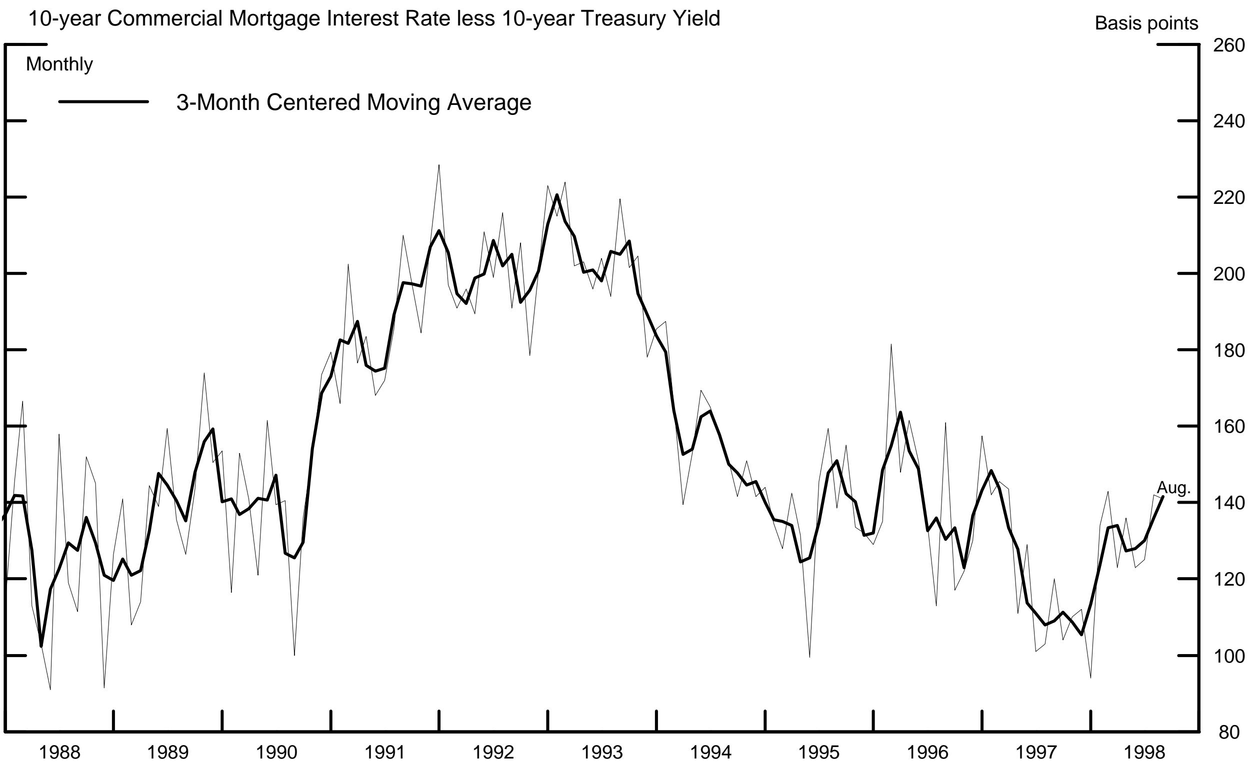
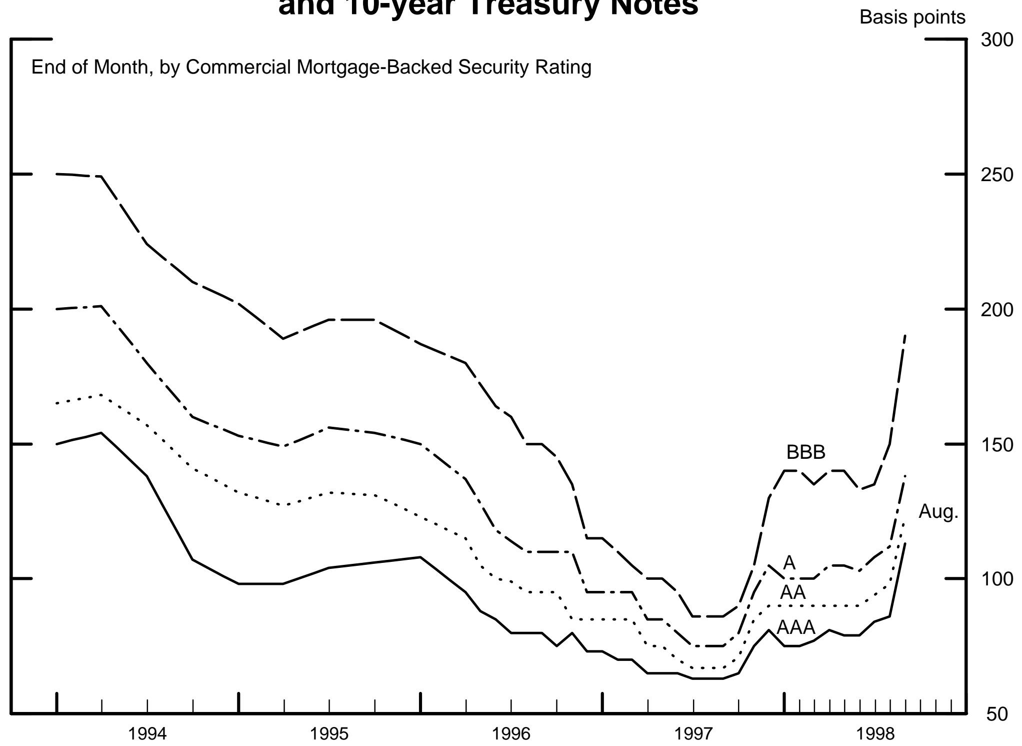


Exhibit 11



Source: Morgan Stanley.

Exhibit 12

Growth of Small Business Loans at U.S. Commercial Banks[1]

Year	Type of loan		
	Total business	Commercial and industrial	Nonfarm, nonresidential real estate
	Amount outstanding, June 30 (billions of dollars)		
1993	295.0	157.2	137.8
1994	294.2	154.5	139.7
1995	315.9	165.3	150.7
1996	333.1	175.8	157.3
1997	357.6	196.1	161.5
1998[2]	370.8	197.2	173.6
	Percentage change, June to June		
1993	--	--	--
1994	-0.3	1.7	1.3
1995	7.4	7.0	7.9
1996	5.4	6.4	4.4
1997	7.4	11.5	2.7
1998[2]	3.7	0.1	7.5

1. Business loans of $1 million or less at U.S. domestically chartered commercial banks, excluding U.S. branches and agencies of foreign banks. U.S. branches and agencies of foreign banks held approximately $178 billion of commercial and industrial loans on June 30, 1998, almost all of which were greater than $1,000,000.
2. Preliminary.

Source: June 30 Call Reports.

Exhibit 13

Securitization of Small Business Loans

Rated Offerings of Securities Backed by Small Business Loans[1]
(Volume in millions of dollars)

Year	Number	Volume
1992	2	574.0
1993	3	376.3
1994	3	201.9
1995	4	211.9
1996	7	530.0
1997	8	489.1
1998[2]	3	212.9
Total	29	2596.1

1. Includes securities backed by the unguaranteed portion of SBA loans, but excludes those backed by the guaranteed portion.
2. Includes data through July 1998.

Source: Moody's, SBA.

Small Business Loans Transferred with Recourse by Commercial Banks[1]
(Millions of dollars)

	Outstanding Principal Balance	Amount of Retained Recourse	Number of Banks
1996 Q1	36.6	5.0	13
Q2	39.8	3.8	8
Q3	38.9	4.1	7
Q4	36.1	5.8	8
1997 Q1	38.0	32.4	8
Q2	186.2	42.7	9
Q3	161.7	19.8	9
Q4	159.1	20.2	6
1998 Q1	151.0	19.4	5
Q2[2]	142.0	19.3	6

1. Recourse refers to the part of the pool of loans that is retained by the bank. This portion of the pool is in a "first loss" position, that is, any shortage in the cumulative repayments on loans in the pool is deducted from the recourse. The Riegle Act allows banks to hold capital against only the recourse that is retained rather than the entire pool.
2. Preliminary.

Source: Call Reports.

Exhibit 14

Small-Business-Loan Securitizations since Mid-1996
(Rated offerings)

Issuer (series)	Issue date	Amount ($ million)	Collateral type	Credit enhancement Amount (percent)	Credit enhancement Type	Class	Credit rating
Emergent Business Capital (1996–1)	11–96	17.5	Unguaranteed portions of SBA loans	9	Subordination		
				6	Spread Account		
		15.9				A	Aa
		1.6				B	n.r.
The Money Store	12–96	140.0	Unguaranteed portions of SBA loans	7	Subordination		
				3.5	Spread Account		
		130.2				A	Aaa
		9.8				B	A
The Money Store	3–97	90.0	First mortgages secured by commercial real estate associated with 504 and 7(a) loans	8	Subordination		
				3.5	Spread Account		
		75.6				A	AAA
		7.2				M	AA
		7.2				B	BBB
Fremont Financial	4–97	109.3	Small-business loans	9	Subordination		
		100.0				A	AAA
		9.3				B	BBB
Sierra West (1997–1)	6–97	51.3	Unguaranteed portions of SBA loans	7	Subordination		
				4	Spread Account		
		47.7				A	Aaa
		3.6				B	A
The Money Store	9–97	140.0	Unguaranteed portions of SBA loans	7	Subordination		
				3.5	Spread Account		
		130.2				A	AAA
		9.8				B	A
Independence Funding (1997–1)	11–97	34.3	Unguaranteed portions of SBA loans	10	Subordination		
				4	Spread Account		
		30.9				A	Aaa
		3.4				B	A

Exhibit 14 cont.

Small-Business-Loan Securitizations since Mid–1996
(Rated offerings)

Issuer (series)	Issue date	Amount ($ million)	Collateral type	Credit enhancement Amount (percent)	Credit enhancement Type	Class	Credit rating
First Western (1997–1)	12–97	22.8	Unguaranteed portions of SBA loans	7 6	Subordination Spread Account		
		21.2				A	Aaa
		1.6				B	A
Business Loan Center (1997–1)	12–97	19.9	Unguaranteed portions of SBA loans	9 4	Subordination Spread Account		
		18.1				A	Aaa
		1.8				B	n.r.
Emergent Business Capital (1997–1)	12–97	21.5	Unguaranteed portions of SBA loans	10 6	Subordination Spread Account		
		19.4				A	A
		2.2				B	n.r.
The Money Store (1998–1)	3–98	90.0	Unguaranteed portions of SBA loans	7 3.5	Subordination Spread Account		
		83.7				A	Aaa
		6.3				B	A
Heller First Capital (1998–1)	6–98	96.0	Unguaranteed portions of SBA loans	4 2	Subordination Spread Account		
		75.9				A	Aaa
		6.7				M–1	AA
		3.8				M–2	A
		5.8				M–3	BBB
		3.8				B	BB
First National Bank of New England (1998–1)	6–98	26.9	Unguaranteed portions of SBA loans	10 7	Subordination Spread Account		
		24.2				A	AA
		2.7				B	n.r.

n.r. Not rated

Source: Moody's, SBA.

Exhibit 15

Small Business Administration 7(a) Loans
(Millions of dollars)

Year	Originated[1]		Securitized[1]	
	Total	Guaranteed part	Total	Guaranteed part
1994	8,177	5,993	2,456	2,300
1995	8,257	5,995	2,042	1,900
1996	7,695	5,736	2,667	2,409
1997	9,462	6,007	2,993	2,703
1998[2]	10,183	7,637	3,136	2,710

1. Volumes originated are for the fiscal year that ends in September. Volumes securitized are for the calendar year.
2. Through June 1998, at an annual rate.

Source: SBA Fiscal Year 1997 Loan Profiles.