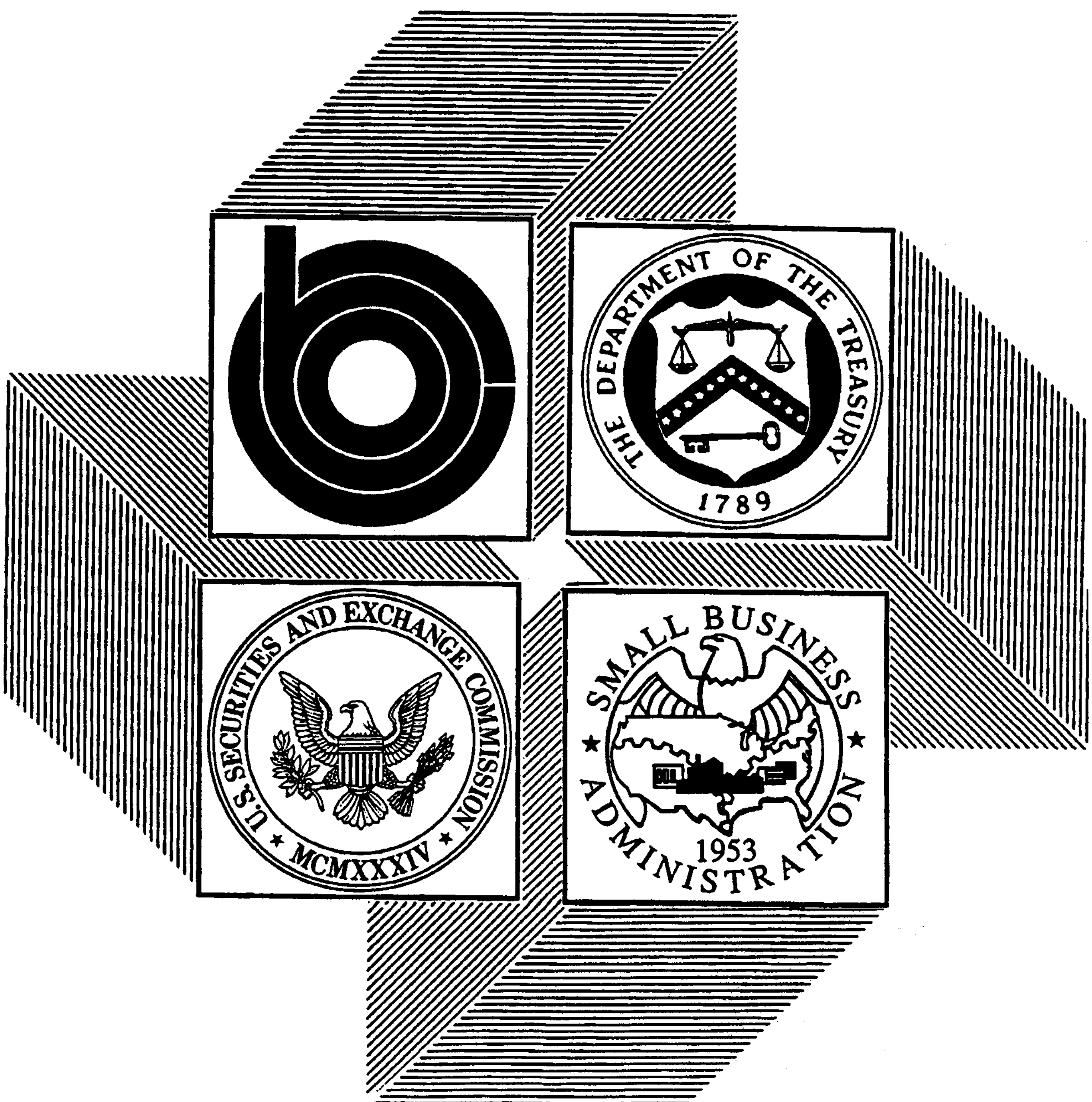
Developing a Secondary Market For Small Business Loans

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

August 26, 1994

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TABLE OF CONTENTS

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:

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

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

- o 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.

- o 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).