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Size of the SBA 7(a) Secondary Markets is Driven by Benefits Provided

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The Honorable Roscoe G. Bartlett
Chairman, Government Programs
and Oversight Subcommittee
House Committee on Small Business
House of Representatives

Dear Mr. Chairman:

As you requested, this report discusses the secondary markets for small business loans guaranteed by the Small Business Administration (SBA); these loans are known as SBA 7(a) loans. The guarantee obligates SBA to repay a participating lender a specific portion of the amount of the 7(a) loan (generally between 75 and 80 percent) in the event of borrower default. The secondary markets allow lenders to sell 7(a) loans they originate and thus obtain funds for further lending. In most such transactions, the 7(a) loans are pooled and sold to investors as tradable financial claims on the cash flows that the pools generate. This pooling of loans is an innovation widely applied in the secondary markets for residential mortgage loans, where whole loans are pooled to create tradable financial claims in the form of mortgage-backed securities (MBS). SBA 7(a) loans are divided into guaranteed and unguaranteed portions, and these are pooled and sold in two separate secondary markets. Cash flows from pools of guaranteed portions are used to back 7(a) pool certificates, which are sold in the guaranteed 7(a) secondary market; cash flows from pools of unguaranteed portions are used to back 7(a) pool securities, which are sold in the unguaranteed 7(a) secondary market.

As agreed with your office, the objectives of this report are to (1) discuss the benefits and risks of secondary loan markets to participants; (2) identify primary benefits and risks to participants in the guaranteed 7(a) secondary market and the unguaranteed 7(a) secondary market; and (3) compare the guaranteed 7(a) secondary market with the secondary market for federally guaranteed residential mortgages, and the unguaranteed 7(a) secondary market with the secondary market for residential mortgages without a federal guarantee. We identified these residential mortgage markets as the most valid comparisons for these objectives.

Results in Brief

The proportion of loans that are sold in a secondary market depends on the benefits generated by that secondary market and how the benefits and risks are distributed among market participants. By linking borrowers and lenders to national capital markets, secondary markets benefit lenders,

borrowers, and investors. These markets (1) tap additional sources of funds, (2) reduce dependence on availability of local funds, (3) help to lower interest rates paid by borrowers, and (4) help lenders manage risks. They provide lenders a funding alternative to deposits and, by enhancing market liquidity,[1] they can reduce regional imbalances in loanable funds. Secondary loan markets can benefit borrowers by increasing the overall availability of credit in the primary market and, through competition among lenders, by lowering the interest rates borrowers pay on loans. Investors in secondary loan markets can benefit from greater liquidity and lower risk than they would get by directly investing in individual loans. Secondary loan market transactions also involve risks that may be borne by the investor or distributed among various market participants.

The secondary markets in 7(a) loans provide lenders a funding source that otherwise would not be available. In calendar year 1997, 1,540 SBA lenders sold 12,164 SBA 7(a) loans in the guaranteed secondary market, generating $2.7 billion in sales of guaranteed portions. About $290 million in sales of unguaranteed portions were made that year by a smaller number of lenders. These were generally Small Business Lending Companies (SBLC), which lack a deposit base, or banks that had not developed a sufficient deposit base as a funding source for their loans.[2] Lenders participating in these markets can reduce funding costs, and investors in 7(a) pool certificates and securities can get greater liquidity and lower risk than they would from directly investing in individual loans.

In the guaranteed 7(a) market, investors face prepayment risk,[3] and in the unguaranteed 7(a) secondary market, investors and lenders share prepayment and credit risk.[4] Both 7(a) secondary markets can help lenders make more loans, which could contribute to a concentration of SBA's credit risk among a few lenders that originate a large percentage of 7(a) loans. In this environment, a sharp increase in defaults, or the failure of one such lender, could be costly to SBA.[5]

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[1] A market is more liquid if market participants can buy and sell large amounts of holdings without affecting the prices of traded securities.

[2] Nondepository lenders, which include SBLCs, were authorized to sell unguaranteed portions in 1992; depository institutions were not authorized to sell unguaranteed portions of 7(a) loans until April 1997.

[3] Prepayment risk is the potential loss of anticipated future income that results from borrowers paying off their loans earlier than expected.

[4] Credit risk is the risk of financial loss due to borrower default.

[5] Our 1998 report, Small Business Administration: Few Reviews of Guaranteed Lenders Have Been Conducted (GAO/GGD-98-85, June 11, 1998), found that SBA had conducted few on-site reviews of its

Compared to the secondary markets for 7(a) loans, the secondary markets for residential mortgages operate with greater incentives for lenders to sell the loans they originate. In 1997, about 45 percent of the guaranteed portions of 7(a) loans originated that year were pooled and sold on the secondary market compared to virtually all federally insured single-family residential mortgages. About 11 percent of the unguaranteed portions of 7(a) loans originated in 1997 were pooled and sold on the secondary market compared to about 32 percent of nonconforming residential mortgages. Notable factors affecting these proportions include the relative (1) preponderance of fixed interest rates in the residential mortgage market, (2) homogeneity of loan characteristics among loans contained in each mortgage pool, and (3) ability of residential mortgage market investors to evaluate the risks associated with each loan pool based on data available to them. Both 7(a) secondary markets lack certain attributes that permit reasonably reliable statistical risk analysis, such as relevant historical data on loan performance and loan homogeneity. Although SBA could undertake actions or policy changes to increase or improve the information provided to investors, such changes could help some 7(a) borrowers and lenders, while others could be adversely affected.

Background

Authorized under section 7(a) of the Small Business Act (15 U.S.C. § 636 (a)), the SBA 7(a) program was established to serve small business borrowers that cannot otherwise obtain private sector financing under suitable terms and conditions. The SBA 7(a) program is SBA's primary vehicle for providing small businesses with access to credit, whereby SBA provides partial guarantees of loans made by SBA-approved private sector lenders. One requirement to obtain a 7(a) loan guarantee, which is backed by the full faith and credit of the U.S. government, is that a lender must document that the prospective borrower was unable to obtain financing under reasonable terms and conditions through normal business channels. SBA authorized secondary markets in 7(a) loans to help lenders manage their funding needs for these loans.

The SBA guarantee encourages lenders to make small business loans by transferring most of an approved loan's credit risk from the loan originator to SBA. The SBA guarantee eliminates credit risk not only for the lenders on the guaranteed portion of 7(a) loans but also for the investor in 7(a)

preferred lenders, indicating that SBA lacked sufficient lender oversight to limit credit risk to the agency, including risk from lender concentration. In commenting on a draft of this report, SBA stated that it has taken significant steps to improve the oversight of participating lenders, including SBLCs. We have not evaluated these initiatives, but they appear to be the type of actions that could mitigate credit risk to the agency resulting from lender concentration.

pool certificates. In addition to the full faith and credit of the U. S. government, the 7(a) pool certificates also carry SBA's timely payment guarantee, which ensures that investors will be paid on scheduled dates when collections from borrowers are not timely.[6]

SBA 7(a) loans are heterogeneous in that they differ in many respects, such as interest rates; repayment schedules; maturity; loan collateral type, quality, and marketability; and type of business to which the loans are made. SBA 7(a) loans are made to a diverse range of small businesses with widely differing financial profiles and credit needs, such as restaurants, consumer services, professional services, and retail outlets.

The dollar volume of 7(a) loans that SBA can guarantee each year is based on congressional appropriations that subsidize the 7(a) guarantee program. For the fiscal year that ended September 30, 1997, SBA approved nearly $9.5 billion in loans--the highest amount to date, and an increase of over 20 percent from the previous fiscal year. As of December 31, 1997, there was $21.5 billion in outstanding 7(a) loans.

According to SBA, about 8,000 lenders are authorized to participate in the 7(a) loan program. They range from institutions that make a few 7(a) loans annually to more active institutions that originate hundreds of 7(a) loans annually. Most are insured depository institutions, such as banks and savings and loan associations. Nondepository lenders include Business and Industrial Development Companies, chartered under state statutes; insurance companies; and SBLCs[7] licensed and regulated by SBA. At the end of 1997, SBLCs accounted for about 19 percent of outstanding 7(a) loans. SBA has established three classifications of lenders within the 7(a) program--regular, certified, and preferred--each having different levels of authority in processing loans. SBA completely analyzes regular lenders' loans and decides on their guarantee. The agency authorizes certified lenders to perform their own credit analyses and preferred lenders to make eligibility and creditworthiness determinations as well as approve their own loans without SBA review.

SBA 7(a) loans differ from other small business loans in some respects. Our 1996 report indicated that 7(a) loans tend to be larger, have longer maturities, and have higher interest rates than small business loans in

[6] Individual 7(a) loans sold in the secondary market carry the SBA guarantee but do not carry a timely payment guarantee.

[7] A moratorium on licensing new SBLCs has been in effect since January 1982.

general.[8] Typically, loans with features such as longer terms and no prepayment penalties warrant higher interest rates. SBA figures showed the average maturity of 7(a) loans sold in the secondary market in 1997 was three times longer than for conventional commercial and industrial loans under $1 million. Also, average interest rates for SBA loans were 67 basis points[9] higher for fixed-rate loans, and 178 basis points higher for variable rate loans, than for respective categories of conventional commercial and industrial loans under $1 million.

In the primary market, single-family residential mortgages differ from 7(a) loans in a number of dimensions that directly affect their respective secondary markets. A majority of residential mortgages have fixed interest rates, and those with adjustable rates have interest rate caps that limit interest rate risk to borrowers. In contrast, 7(a) loans consist primarily of variable rate loans without interest rate caps. As a result, lenders face more interest rate risk[10] on residential mortgages than on 7(a) loans. Residential mortgage loans are more homogeneous than 7(a) loans because the terms are standardized, and collateral, residential property, is the same.

In order to provide a perspective of how the 7(a) markets compare with other secondary markets, we compared the two secondary markets in 7(a) loan portions to the secondary markets for single-family residential mortgages as follows:

- The secondary market for single-family residential mortgages which has federal mortgage insurance provided by the Federal Housing Administration (FHA), a government corporation within the Department of Housing and Urban Development (HUD). These mortgages are fully insured in the event of borrower default. Lenders who originate FHA-insured mortgages can pool them and issue MBS guaranteed by the Government National Mortgage Association (Ginnie Mae), another government corporation within HUD, which, for a fee, guarantees timely payment of principal and interest to investors. We compared this secondary market[11] to the guaranteed 7(a) secondary market.

[8] Small Business: A Comparison of SBA's 7(a) Loans and Borrowers With Other Loans and Borrowers (GAO/RCED-96-222, Sept. 20, 1996).

[9] A basis point is one one-hundredth of a percentage point.

[10] Interest rate risk is the risk of financial loss due to changes in market interest rates.

[11] A similar secondary market exists for conventional single-family residential mortgages, which have no federal mortgage insurance. Lenders who originate conventional mortgages below a statutory

- The secondary market in conventional, single-family residential mortgages that have loan amounts, or other characteristics that preclude purchase by Fannie Mae or Freddie Mac. These are called nonconforming mortgage loans. In this secondary market, state-chartered private corporations--referred to as private-label conduits--pool mortgages they purchase and issue MBS. We compare features of this market to the unguaranteed 7(a) loan secondary market.

The benefit to individual lenders of selling loans in a secondary market depends in part on demand for that lender's loans and availability and costs of the lender's alternative funding sources. Other considerations include whether holding loans on the balance sheet or selling them in the secondary market brings higher returns on invested capital and/or lowers the lender's risks.

Scope and Methodology

To meet our report objectives, we reviewed SBA's standard operating procedures for the 7(a) program and other SBA documents addressing the role of the secondary markets for 7(a) loans.[12] We also reviewed research conducted by SBA, HUD, other federal agencies, and others on the workings of the 7(a) markets; secondary markets for conventional small business loans; and residential mortgage loan secondary markets. We analyzed data on the 7(a) program from SBA as well as publicly available information on the residential mortgage market. We also talked to SBA officials and officials of its fiscal and transfer agent, Colson Services, Corp.; Ginnie Mae; HUD; the National Association of Government Guaranteed Lenders; the Bond Market Association; the American Bankers Association; the Independent Bankers Association; participating 7(a) lenders and poolers; other participants in the small business loan markets; the Office of Federal Housing Enterprise Oversight (OFHEO); the Board of Governors of the Federal Reserve System; the Office of the Comptroller of the Currency; and the Securities and Exchange Commission (SEC).

To meet our third objective, we analyzed the secondary market in residential mortgages to determine which parts of that market to use for

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dollar level can sell them to the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac), two private corporations with federal charters. These two corporations are called government-sponsored enterprises (the enterprises) and with a majority of their mortgage purchases, they pool the mortgages and issue MBS backed by these loans. These enterprises normally provide corporate guarantees on MBS they issue, which eliminate credit risk for MBS investors. This secondary market has features that we compare to the guaranteed and unguaranteed secondary markets in 7(a) loans.

[12] The SBA documents we reviewed included SBA rulemaking efforts directed at the unguaranteed secondary market for 7(a) securities and the comments submitted during the course of SBA rulemaking efforts.

comparative purposes in this report. The secondary market in residential mortgages is divided into three broad parts. The first part is based on federally insured/guaranteed mortgages provided by FHA or the Department of Veterans Affairs (VA). In this market, residential mortgage loans are pooled to create tradable financial claims in the form of securities, with pool guarantees from Ginnie Mae. A majority of mortgages backing Ginnie Mae MBS are FHA-insured mortgages. We deemed this secondary market analogous to the guaranteed 7(a) market for purposes of this report. A second part of the secondary market is for mortgages that conform to underwriting standards created by the enterprises. Although the government does not guarantee these mortgages, the private sector perceives the federal connections of the enterprises as providing an implicit guarantee and takes into account their pool guarantees. The last part of the secondary residential mortgage markets includes nonconforming mortgages that are fully private and pooled without implicit or explicit government guarantees. We deemed this secondary market analogous to the unguaranteed 7(a) secondary market for this report's purposes.

In our review of disclosures made to investors in guaranteed 7(a) pool certificates, we relied on SBA regulations and information obtained in discussions with SBA and Colson officials. For unguaranteed pool securities, we reviewed offering statements from an issuer of SEC-registered, publicly offered 7(a) pool securities, but we did not obtain offering statements or materials for 7(a) pool certificates or 7(a) pool securities that were not SEC registered. We used information from financial industry publications, Ginnie Mae disclosure forms and offering statements to determine financial disclosure information provided on the various forms of MBS.

We conducted our work in Washington, D.C., between September 1997 and December 1998 in accordance with generally accepted government auditing standards.

We provided copies of a draft of this report to SBA for review and comment. SBA's Associate Deputy Administrator for Capital Access provided written comments on the draft report, which are summarized on page 34 and reprinted in appendix IV. SBA and Ginnie Mae provided technical comments on the draft report, which have been incorporated where appropriate.

Secondary Loan Markets Generate Benefits and Concerns

Secondary loan markets, which are resale markets for loans originated in primary markets, link borrowers and lenders in local markets to national capital markets, lower costs for funds, and help lenders manage risks. This linkage provides an additional source of funds for lenders that can increase lenders' liquidity. Borrowers can benefit from the ensuing increase in funds availability and from lower interest rates that result from lender competition. Investors in secondary loan markets can benefit by holding more liquid financial instruments than they would have from investing directly in individual loans.

The major risks in secondary loan market transactions--as well as in primary market lending--are credit, prepayment, and interest rate risks. Investors, guarantors, and lending institutions that securitize loan pools can suffer losses or incur costs as a result of one or more of these risks in the secondary markets. The levels and types of risk, as well as the parties that incur risk, can differ as well. These variables are important determinants of the share of loans in a particular primary market that are sold in secondary markets. Factors bearing on individual lenders' decisions to sell their loans in a secondary market include loan demand, the availability and costs of alternative funding sources, and the relative risks or returns from selling loans on the secondary market compared to holding them. The share of loans in a primary market that are sold in a secondary market depends on the benefits generated by the secondary market.

Lenders, Borrowers, and Investors Can Benefit From Secondary Loan Markets

Secondary loan markets can generate a number of benefits for lenders and borrowers. The secondary loan markets provide an alternative funding source in addition to deposits and other funding sources, such as lines of credit and debt issuance proceeds. Selling their loans on the secondary markets provides lenders more flexibility in managing their liquidity needs. They can generate funds for additional lending, earn fee income by servicing the sold loans,[13] or avoid tying up capital. The resulting liquidity can reduce regional imbalances or cyclical swings in loanable funds. Borrowers can benefit from increased credit availability, and competition among lenders can provide borrowers with lower interest rates. By investing in pools of loans, investors can diversify their risks among a number of loans rather than having them concentrated in one loan. Investors can sell their interests on active secondary markets to other willing investors.

[13] Lenders service the types of loans discussed in this report by collecting payments from borrowers and making scheduled payments to investors, as well as meeting requirements when borrower payments are late or defaults occur.

Credit, Prepayment, and Interest Rate Risks Are Primary Risks in Secondary Loan Markets

The primary risks that can affect the cash flows generated by loan pools in secondary loan markets are credit, prepayment, and interest rate risks. A variety of factors affect the levels of these risks in secondary loan market transactions as well as the parties that incur them, as illustrated by the following general observations:

- Credit risk levels depend upon characteristics of the pooled loans that back a security, such as borrowers' credit worthiness, the collateral securing the loans, the type of business financed, and the pool's geographic diversity.
- The federal government--and therefore U.S. taxpayers--bears the credit risk on securities backed by pooled loans with federal guarantees.
- The investor and the lender share credit risk on securities with credit enhancements[14] provided by the lender.
- The level of prepayment risk in a security depends, in part, on whether prepayment penalties are included on the pooled loans backing a security.
- The nature of the interest rates on loans--fixed or variable--affects the level of interest rate risk.

Since the inherent credit, prepayment, and interest rate risks are important to investors, the ability to estimate returns and risks of securitized loan pools is also important.

[14] A credit enhancement is a payment support feature that covers defaults and losses up to a specific amount on loans backing a security, thereby reducing investor need for loan-specific information. It acts to increase the likelihood that investors will receive interest and principal payments in the event that full payment is not received on the underlying loans.

Reliable estimates of returns and risks are more likely when historical data on the performance of similar loans under varying economic conditions are available and when loan pools are homogeneous. When historical data include the loss experience of many comparable loans under a wide variety of economic conditions, investors and analysts can calculate loss probability distributions that predict the likely losses for a pool of similar and homogeneous loans. However, the less alike the loans are, the more troublesome it can be to estimate cash flows or the likelihood of losses. Although more precise cash flow estimates improve investors' ability to estimate or measure risk, they may also lower returns because investors want to be compensated according to the degree of risk they undertake. Therefore, when less precise estimates can be made, both risks and returns to investors are generally higher. Monetary benefits to lenders from participating in the secondary market lessen when they must pay investors high returns.

Secondary Loan Market Benefits to Individual Lenders Depend on Several Factors

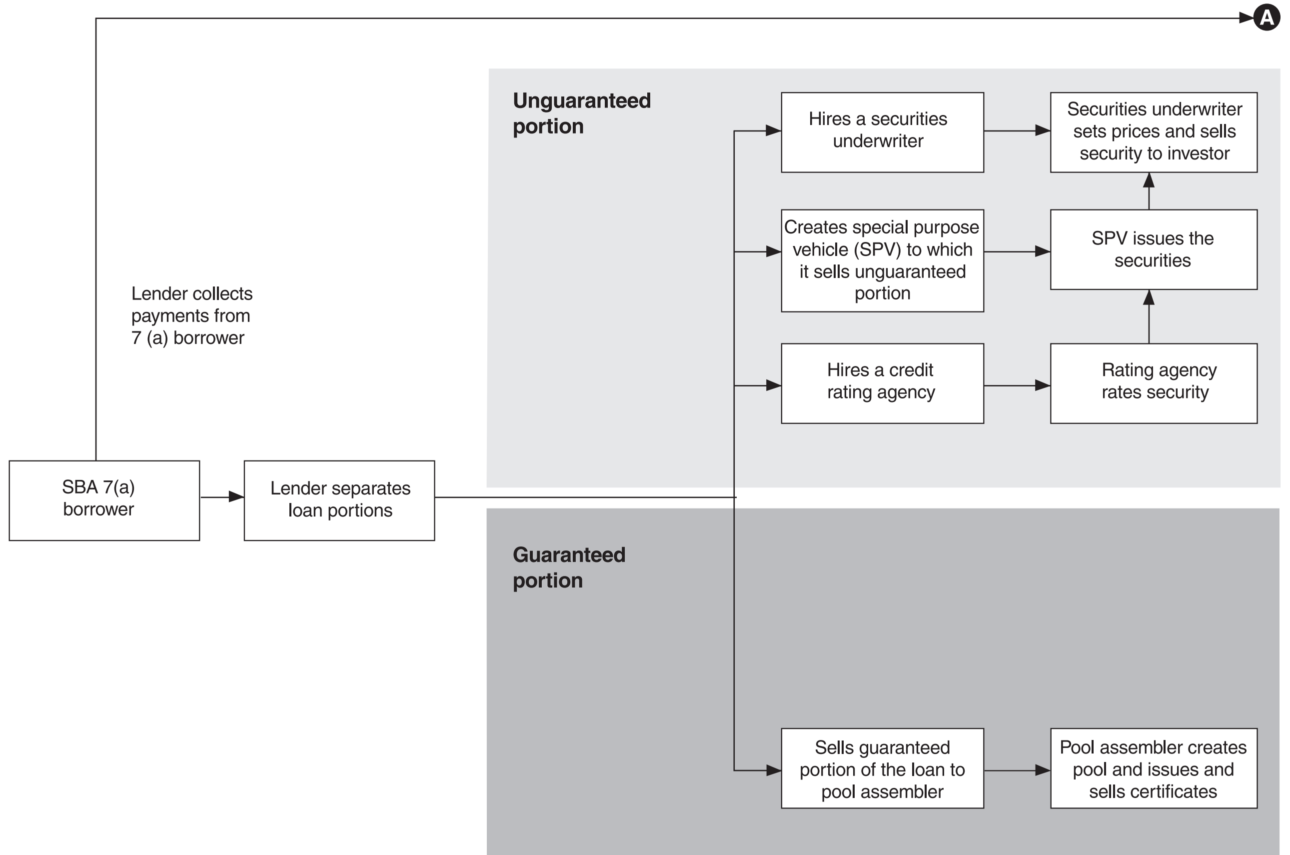
As discussed earlier, secondary loan markets give lenders a funding alternative to deposits and other funding sources, such as lines of credit and the proceeds from debt issuances. The benefit to an individual lender of selling loans in a secondary market depends in part on the comparative costs of its available funding sources. For example, a lender that has access to adequate funding to meet the demand for loans, consistent with its business plan, may lack funding-related incentives to participate in secondary loan markets. The benefit of secondary markets to individual lenders also depends on whether holding loans on the balance sheet or selling them in the secondary market can best increase returns on invested capital and/or lower risks for the lender. For example, a financial institution holding long-term fixed rate loans financed by variable rate liabilities is subject to interest rate risk, which the institution could reduce by selling these loans on the secondary market.

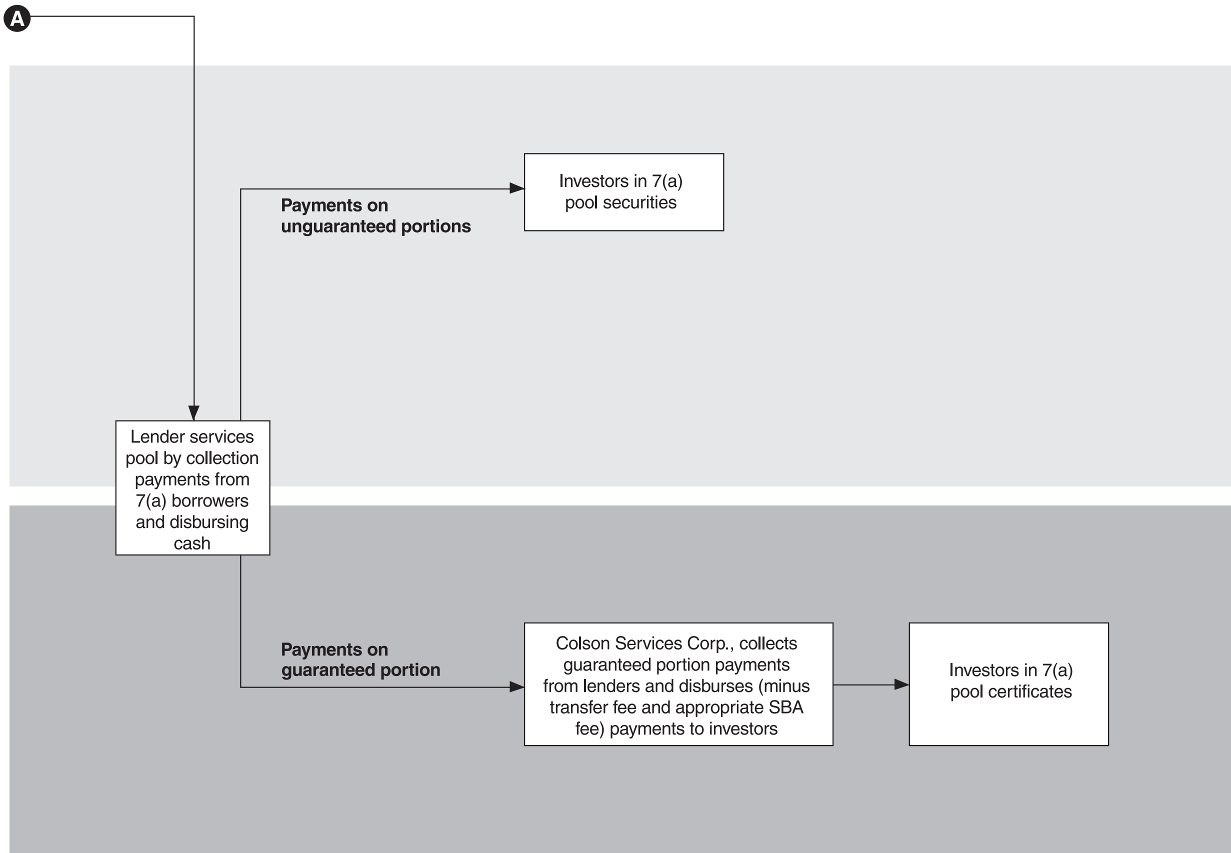
The Secondary Markets in SBA 7(a) Loans Generate Benefits and Risks

In linking 7(a) borrowers and lenders from local markets to the national capital markets, the 7(a) secondary markets--particularly the market for guaranteed portions--benefit lenders, borrowers, and investors. The 7(a) secondary markets can help borrowers and lenders by reducing regional imbalances and cyclical swings in credit availability and pricing. In 1997, the guaranteed 7(a) secondary market served as a funding source for many

lenders, particularly for about 50 institutions that generally lacked deposit bases, according to an SBA official. The 7(a) secondary markets can also help qualified borrowers by providing a means to lower interest rates or to make 7(a) loans available at more favorable terms. Institutional investors in 7(a) pool certificates and securities--including pension funds, mutual funds, insurance companies, and others--benefit from the greater liquidity and lower risks in pool certificates and securities compared to investments in individual loans. Figure 1 illustrates differences in how the guaranteed and unguaranteed markets work.

Figure 1: The 7(a) Loan Pooling Process





Source: SBA.

Investors, poolers, lenders, and SBA face various risks from the 7(a) secondary markets.[15] Investors in the guaranteed 7(a) market face prepayment risk, and investors and lenders in the unguaranteed 7(a) secondary market share prepayment and credit risks. The heterogeneity of 7(a) loans makes estimation of risks difficult for investors and limits the overall benefits of the secondary markets. Another limiting factor is the fact that interest rate risk in the 7(a) markets is less because most 7(a) loans have variable interest rates pegged to current prime market rates. Interest rate risk is less likely to be a factor for most depositories because few 7(a) loans have fixed interest rates.

[15] Because most 7(a) loans have variable interest rates without interest rate caps, we do not discuss interest rate risk here.

SBA faces the possibility of a concentration of credit risk from both 7(a) secondary markets. The combination of the potentially large amount of funds and economies of scale that individual lenders may achieve by increasing the number of 7(a) loans they sell could result in a concentration of 7(a) loans serviced by one or a few lenders. A sharp increase in loan defaults by, or the failure of, one such lender could be costly to SBA, which lacks controls for concentration risk. Moreover, our 1998 report[16] cited inadequacies in SBA's efforts to ensure sound SBLC lending practices. While the participation of rating agencies in the unguaranteed marketplace encourages lenders to follow prudent lending practices, this factor alone may not adequately limit SBA's credit risk from lender concentration. Although high ratings on securities backed by unguaranteed portions of 7(a) loans may indicate that lenders have followed prudent lending practices, lenders may be able to change these practices and operate for some time before the ratings are lowered to reflect the change, thus some credit risk from lender concentration remains.

The 7(a) Secondary Markets Generate Benefits for Many Depository and Nondepository Institutions

In calendar year 1997, 1,540 SBA lenders sold 12,164 7(a) loans (about 45 percent of the 7(a) loans approved during the most recent fiscal year) in the guaranteed secondary market and collectively generated $2.7 billion in sales. About 50 of those lenders used the guaranteed 7(a) market extensively, selling every 7(a) loan they originated, according to an SBA official. These lenders generally lacked a sufficient deposit base to fund their loans.

The unguaranteed 7(a) secondary market is much smaller than the guaranteed 7(a) market. At the end of 1997, the total guaranteed portions of outstanding 7(a) loans was $10 billion. Only nine 7(a) lenders—six nondepository lenders and three depository lenders—had securitized 20 pools of unguaranteed portions of 7(a) loans. One of these lenders, The Money Store, was responsible for 8 of the transactions, which accounted for about two-thirds of the total $1.25 billion in unguaranteed portions securitized since 1992.

Only Nondepository Lenders Were Authorized to Sell Unguaranteed Portions of 7(a) Loans in the Secondary Market From 1992 Through 1996

In 1992 , SBA authorized the creation of the unguaranteed secondary market as a funding source for nondepository institutions. Since that time, these lenders have been able to sell pools of unguaranteed portions of their 7(a) loans in the secondary market. In 1996, Congress mandated that SBA revise its rules to allow all lenders to sell the unguaranteed portions of their 7(a) loans on the secondary market. In April 1997, SBA

[16] GAO/GGD-98-85, June 11, 1998.

promulgated an interim rule that extended the provisions of the previous rule to include all participating 7(a) lenders. Under the interim rule, SBA was to review each proposed securitization on a case-by-case basis for safety and soundness concerns. The interim rule remained in effect until April 12, 1999, when SBA's final rule, promulgated February 10, 1999, became effective.

The unguaranteed 7(a) secondary market comprises buyers and sellers of securities backed by the unguaranteed portions of 7(a) loans. Securities backed by unguaranteed portions of 7(a) loan portions can be issued and sold to investors in either public offerings or private placements. Unlike certificates backed by guaranteed portions of 7(a) loans, the public sale of these securities is subject to SEC registration and disclosure requirements. The Securities Act of 1933 requires that securities sold in a public offering be registered with SEC before they are distributed and that certain information regarding the securities and the issuer of the securities must be disclosed to prospective buyers.[17] Issuers can avoid the costly registration and reporting process required of public offerings by offering the securities in private placements. Private placements must be made on a limited basis to selected persons, and not be part of a general public solicitation. In general, private placements are less liquid than publicly traded securities. Eight of the 20 pools of unguaranteed portions of 7(a) loans were sold in public offerings.

Securities backed by unguaranteed portions generally carry one or more credit enhancements to raise the ratings of these securities and attract investors. As of December 31, 1998, the senior class of all 20 securitizations of unguaranteed portions had investment grade ratings.

Borrowers Benefit From the 7(a) Secondary Markets

Although constrained by annual congressional appropriations for the 7(a) loan program, the 7(a) secondary markets can benefit borrowers of program loans by making loans available at more favorable terms, as other secondary markets do. Lenders that profit from the secondary markets may pass on some of their gains from lower funding costs to borrowers in the form of lower interest rates. Growth in SBA's lending authority has accelerated since 1985, when SBA first allowed lenders to pool guaranteed portions of 7(a) loans for secondary market sales. SBA's annual 7(a) loan volume grew steadily from $2.3 billion in fiscal year 1985 to $3.1 billion in fiscal year 1991, and $9.5 billion in fiscal year 1997.

[17] The Securities Exchange Act of 1934 requires continuing disclosure after a security is issued.

Investors Benefit From the 7(a) Secondary Markets

Secondary markets for investments backed by SBA 7(a) loan pools attract a wide range of institutional investors, including pension funds, mutual funds, insurance companies, and others that might not otherwise consider investing in small business loans. Investors in 7(a) pool certificates and securities benefit from greater liquidity and lower risks than they would get from investing directly in individual loans, because these instruments can be sold more easily than individual loans, and risks are dispersed among the pooled loans.

Investors Purchasing Unguaranteed Portions of 7(a) Loans Face Credit and Prepayment Risks

Investors in guaranteed portions do not face credit risk because the SBA guarantee transfers that risk from the investor to SBA. Investors who purchase 7(a) pool securities backed by unguaranteed portions face both credit and prepayment risks. They typically share the credit risk with the lender. That is, SBA 7(a) pool securities typically carry one or more forms of lender-provided credit enhancement, which reduces credit risk and makes the securities more attractive to investors. The most common form of credit enhancement uses excess spread,[18] which is a cash reserve funded by a portion of collections from borrowers' loan payments on guaranteed and unguaranteed portions of the loans. Another common form of credit enhancement used with securities backed by unguaranteed portions is subordination. In subordination, at least two classes of security are created, with the subordinate classes subject to absorbing a prescribed amount of losses on the loans backing the securities. Credit enhancements provide funds to maintain scheduled payments to investors if borrowers go into default or are late in making payments. Such enhancements are required by credit rating agencies to bring securities to investment-grade ratings, as they act to mitigate credit risk. Providing such loss protection comes at a cost to the lender. The higher the credit enhancement needed to sell the securities, the lower the net proceeds to the lender from the sale of the securities and therefore the incentive to securitize the loans.

Investors and analysts can generally make more reliable estimates of the returns and risks of loan pools when they are homogeneous and when historical data are available on the performance of similar loans under varying economic conditions. The availability of large bases of historical data that include the loss experience of many comparable loans can enable

[18] Excess spread is the difference, after expenses, between scheduled collections from borrowers whose loans are in a particular pool and scheduled payments to investors in the certificates or securities that are backed by the pool. It is stated as a percentage of the total amount of the loans in the pool. For example, a spread of 1 percent could mean that scheduled collections from borrowers reflect an aggregate interest rate of 8 percent, and scheduled payments to investors reflect an investment yield of 7 percent.

investors and analysts to estimate loss probability distributions from those data and use the results to predict the expected loss experience for a pool of similar and homogeneous loans. When secondary market investors face high levels of credit risk or lack information to estimate such risks, they demand greater credit enhancements and yields. These factors act to lower the prices investors will pay for securities backed by the unguaranteed portion of 7(a) loans.

A discussion of how credit rating agencies determine ratings for SBA loan-backed securitizations appears in appendix I.

Investors in 7(a) Pool Certificates Face Prepayment Risk

To compensate for prepayment risk, investors demand higher yields on 7(a) pool certificates than on Treasury securities with comparable maturities. As with Treasury securities, the U.S. government bears the credit risk on SBA pool certificates backed by guaranteed portions of 7(a) loans, but it does not bear the credit risk for securities backed by unguaranteed portions of 7(a) loans. Therefore, excess spread from guaranteed certificates is set aside to shoulder some of the credit risk burden associated with the unguaranteed portions of 7(a) loans. This use of excess spread as a credit enhancement affects the spread between the interest rate the borrower pays and the rate paid to investors in 7(a) pool certificates.

To address prepayment concerns, the Bond Market Association has proposed that SBA consider imposing prepayment penalties structured to reduce borrower incentives to refinance 7(a) loans as nonguaranteed commercial loans at marginally lower rates. While flexibility for some borrowers would be constrained if prepayment penalties were imposed, 7(a) loans with such prepayment penalties could lead to more favorable loan terms for borrowers. Such a feature in 7(a) loans, and often present in commercial business loans, would also mean less prepayment risk for investors in the 7(a) secondary market.

A discussion of the mechanics of the guaranteed 7(a) secondary market appears in appendix II.

Although the 7(a) Secondary Markets Help SBA Serve Small Business Borrowers, They Provide a Means for Concentration of Credit Risk

The 7(a) secondary markets could also be instrumental in contributing to a concentration of credit risk for SBA. Because SBA generally guarantees 75 to 80 percent of each 7(a) loan, the failure of one or more large lenders to follow prudent lending practices necessary for making creditworthy loans can expose SBA to credit risk once those loans go into default. As a large potential funding source for lenders, the 7(a) secondary markets can enable lenders active in the secondary markets to increase loan volume, and the existence of economies of scale could possibly lead to concentration of the 7(a) portfolio among a few lenders.

Through the rating process, the marketplace encourages lenders to follow prudent lending practices and provide credit enhancements that will protect investors to a certain degree. However, this alone may not provide sufficient lender discipline to limit credit risk to SBA resulting from concentration of 7(a) loans in the servicing portfolio of a large lender that does not follow prudent lending practices. Although high ratings on securities backed by unguaranteed portions of 7(a) loans may indicate that lenders have followed prudent lending practices, lenders may be able to change these practices and operate for some time before the ratings are lowered to reflect the change, thus some credit risk from lender concentration remains.

Our 1998 report[19] noted that weaknesses existed in regulatory oversight to help ensure that the 7(a) lenders comply with requirements that mitigate SBA's credit risk. It stated that SBA had established various lender standards and loan policies and procedures to help ensure that lenders follow prudent lending standards. However, the report noted, without conducting periodic, on-site lender reviews, SBA had no systematic means to help ensure that lenders' actions did not render loans ineligible, uncreditworthy, or uncollectible, and thus increased the risk of loss to the agency. Although financial institution regulators help ensure safe and sound operations, their oversight does not necessarily ensure that 7(a) portfolios are managed prudently. Perhaps of greater importance were weaknesses in oversight of SBLCs, which are licensed, regulated, and supervised by SBA. In our 1998 review of 5 of SBA's 69 district offices, we found that SBA had not conducted the regular, periodic reviews of lender compliance with its 7(a) loan standards or met its own standards for SBLC oversight. In commenting on this report (see app. IV), SBA stated that it has since reviewed all preferred lenders, and that the Farm Credit Administration, through an agreement with SBA, has completed the on-site portions of the SBLC reviews. While we have not evaluated these

[19] GAO/GGD-98-85.

initiatives, they appear to be the type of actions that could mitigate credit risk to the agency resulting from lender concentration.

SBA's final rule, promulgated February 10, 1999, and effective April 12, 1999, includes provisions that are intended to control the agency's credit risk in the 7(a) program. As discussed in further detail in appendix II, the final rule stipulates capital requirements for lenders and establishes requirements that lenders retain a subordinated interest in securities they create, based on each lender's loss rate. The final rule also provides a monitoring component whereby a decline in a securitizer's performance would trigger suspension of certain lending privileges.

Comparison of the SBA 7(a) Secondary Markets With the Secondary Markets for Residential Mortgages

The pooling of loans in the 7(a) secondary market is an innovation widely applied in the much larger secondary markets for single-family[20] residential mortgage loans, where whole mortgage loans, rather than separate portions of loans, are pooled to create tradable financial claims in the form of MBS. Compared to the secondary markets for 7(a) loans, the secondary markets for residential mortgages operate with greater incentives for lenders to sell the loans they originate. A comparatively greater proportion of mortgage lenders has an economic incentive to sell loans in the secondary market because they rely on secondary mortgage markets as their most important source of funding. In addition, depository institutions' needs to manage interest rate risk associated with mortgage loans, coupled with risk-management opportunities provided by the secondary markets, provide an important incentive for those lenders to sell mortgage loans they originate. These factors, as well as the comparatively larger size of the primary and secondary markets in residential mortgages, contribute to larger percentages of residential mortgages being sold in secondary markets compared to 7(a) loans sold in 7(a) secondary markets. In the secondary mortgage markets, investors are better able to estimate cash flows and risks from investments backed by pools of mortgage loans. Investors are comparatively less able to reliably estimate cash flows and risks from investments backed by 7(a) loans because they lack historical data on the performance of similar loans under varying economic conditions and because the loan pools are heterogeneous.

Nearly all federally insured single-family mortgages originated in 1997 were sold on the Ginnie Mae secondary market, compared to about 45 percent of the guaranteed portions of 7(a) loans on its respective secondary market. In the secondary market for conventional single-family

[20] Housing units contained in structures with one to four housing units are considered single-family housing units.

residential mortgages without federal insurance, also known as the conventional conforming market, about 46 percent of the mortgages originated in 1997 and eligible for purchase by the enterprises was sold compared to about 11 percent of unguaranteed portions of 7(a) loans originated that year. Among single-family conventional residential mortgages originated in 1997 and not eligible for purchase by the enterprises, about one-third were sold in this secondary market, called the nonconforming market. The percentage of conventional mortgages, both conforming and nonconforming, that were originated and sold in secondary markets was much greater than that for the unguaranteed portions of 7(a) loans. In addition, a greater percentage of fixed-rate conventional mortgage loans was sold in secondary markets than variable-rate loans.

Greater homogeneity of single-family residential mortgage loans compared to 7(a) loans contributes to a higher percentage of loans sold in secondary markets. Similarities among residential mortgage loans, such as being backed by the same types of collateral, along with standard loan terms, increases the ability of secondary market investors to evaluate cash flows and loan collateral values and therefore the various risks associated with purchasing MBS.

Finally, the bigger sizes of the primary and secondary markets in residential mortgages relative to the respective markets in 7(a) loans contribute to the larger percentages of residential mortgages sold in secondary markets. Large mortgage loan pools allow more precise risk estimates and lower fees (per dollar loaned) associated with maintaining a secondary market. Table 1 displays statistics on the shares of residential mortgage loans and guaranteed portions of 7(a) loans sold in secondary markets in 1997.

Table 1: Residential Mortgages and Portions of 7(a) Loans Originated and Sold in Secondary Markets in 1997

Dollars in billions

	Originated	Sold	Percent sold
Federally insured mortgages	$102	$102	100
Conventional conforming mortgages	560	257	46
Nonconforming conventional mortgages	198	63	32

Dollars in billions	Originated	Sold	Percent sold
Total conventional mortgages	758	320	42
Unguaranteed portions of 7(a) loans	2.7	.29	11
Guaranteed portions of 7(a) loans	6.0	2.7	45

Sources: OFHEO and SBA.

Some Institutions Rely on Secondary Markets as a Primary Source of Funds

Nondepository institutions benefit relatively more from these secondary markets because they do not have a deposit base with which to finance the loans they make. Mortgage companies originate mortgages for resale in the secondary markets as a means to fund further mortgage originations. These companies retain servicing rights when they sell mortgages, thereby earning income from collecting and processing mortgage payments. Mortgage companies include independent firms without deposit bases as well as subsidiaries of depository institutions. They originate about three-fourths of federally insured, and about one-half of conventional, single-family mortgage loans. Because they can use the proceeds of their secondary market loan sales to finance more mortgage loans, the secondary mortgage markets allow mortgage companies to compete in the primary market for loan origination and servicing, even though they do not have a deposit base to finance the mortgages on their balance sheets. One reason mortgage companies originate a higher share of federally insured than conventional mortgages is the presence of an active secondary market in federally insured, fixed-rate residential mortgages dating back to the 1930s.

Unlike the mortgage market where nondepository institutions originate a majority of the loans, the vast majority of 7(a) loans are originated by depository institutions. However, as with mortgage loans, the 7(a) secondary markets allow nondepository institutions to compete in the primary 7(a) market for loan origination and servicing, even though they do not have a deposit base to finance 7(a) loans on their balance sheets.[21] While mortgage companies fund mortgages from origination until time of sale in the secondary market, they do not permanently fund any portion of the originated loans on their balance sheets. In contrast, SBLCs have used debt sources, such as bank lines of credit, to fund the unguaranteed portion of 7(a) loans on their balance sheets. At the end of 1997, SBLCs accounted for about 19 percent of outstanding 7(a) loans.

[21] Some SBLCs have funded unguaranteed portions of 7(a) loans without relying on the unguaranteed secondary market for funds.

Depository Institutions Use the Secondary Markets to Manage Interest Rate Risk

The presence of interest rate risk in a primary market increases the attractiveness of the secondary market to loan originators who may depend on a deposit base as a permanent funding source. Depository institutions can use their deposit base as a source of funding with costs that fluctuate frequently. These institutions use the secondary markets to manage interest rate risks. Long-term, fixed-rate loans generate interest rate risk for lenders who depend on a deposit base for funding loans because increases in short-term funding costs are not accompanied by increases in interest payments on existing loans.[22] Variable-rate loans, of which adjustable-rate mortgages are one type, can also generate interest rate risk for lenders if caps are imposed on the maximum allowable increases in interest rates.

Prior to the 1990s, virtually all FHA-insured mortgages were fixed-rate.[23] Currently, over 70 percent of FHA-insured mortgages are fixed-rate mortgages. In addition, for adjustable-rate mortgages, FHA limits the degree to which interest rates paid by the borrower can increase to a maximum of 1 percentage point annually and 5 percentage points over the life of the mortgage loan, which acts to limit interest rate risk to the borrower but shifts this risk to the lender. As a result, FHA-insured adjustable-rate mortgages also entail interest rate risk for lenders. Nearly all federally insured residential mortgages were sold in the Ginnie Mae guaranteed secondary mortgage market in 1997.[24] By comparison, about 45 percent of guaranteed portions of 7(a) loans were sold in the guaranteed secondary market in 1997.

Over the past decade, depository institutions have played a relatively larger role in the origination of conventional rather than federally insured mortgages. Adjustable-rate mortgages currently account for about 20 to 25 percent of all single-family conventional mortgages.[25] That percentage has been higher for nonconforming conventional mortgage loans originated.[26]

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[22] Even in the absence of interest rate risk, mortgage bankers sell residential mortgage loans they originate in the secondary market.

[23] In our analysis of the secondary market for federally insured residential mortgages, we focused on the major primary market comprised of FHA-insured residential mortgages.

[24] The active, long-standing secondary market in fixed-rate, federally insured mortgages dating from the 1930s; the greater presence of mortgage companies in the primary, federally insured origination market; and the higher interest rate risk on federally insured mortgages contribute to this outcome.

[25] OFHEO estimates based on monthly survey tabulations compiled by the Federal Housing Finance Board.

[26] This observation is based on an analysis using mortgage origination data for the years 1989 through 1993.

Interest rate caps vary among conventional mortgages, but most typically are 2 percentage points annually and 6 percentage points over the life of the mortgage loan. These more flexible caps allow for less interest rate risk to the lender on conventional than on FHA-insured adjustable-rate mortgages. Based on the assumption that 20 to 25 percent of all single-family residential mortgages are adjustable rate, in the overall single-family residential mortgage market (i.e., federally insured and conventional), roughly 30 percent of adjustable-rate, and slightly over 50 percent of fixed-rate, outstanding mortgage loans were sold in secondary markets.[27] The 30-percent figure for adjustable-rate mortgages generally corresponds to the percentage of the guaranteed portions of 7(a) loans sold in its secondary market.

In contrast to mortgage loans where fixed-rate loans prevail, about 90 percent of 7(a) loans originated in 1997 were variable-rate loans that adjust quarterly without interest rate caps. Because of this, depository institutions have minimal exposure to interest rate risk when they use their deposit bases to finance 7(a) loans and thus have less incentive to sell on the secondary market than if their risk were higher.[28]

Prepayment Risk Exists in Residential Mortgage and 7(a) Secondary Markets

MBS investors face prepayment risk that mortgage buyers will pay off their mortgages before the final payment date. Residential mortgage borrowers typically prepay their fixed-rate mortgage loans when mortgage interest rates decline significantly below that of their existing mortgage. As a result, investors in MBS backed by cash flows from fixed-rate mortgage loans may not benefit from higher yields when interest rates in the economy decrease because many of the mortgages backing the MBS may be paid off, thereby terminating the cash flows from those mortgages. The yield for these investors, however, does not increase when interest rates in the economy rise above those in the mortgages backing the MBS. SBA 7(a) borrowers typically prepay when they find better alternatives; from the standpoint of the investor prepayment also occurs with borrower default. Because most 7(a) loans have variable interest rates, prepayments based on economywide interest rate changes are less likely.

[27] OFHEO estimates based on statistics presented in Inside Mortgage Finance (1997 annual) and the assumption that between 20 and 25 percent of single-family residential mortgages outstanding at year-end 1997 were adjustable rate.

[28] Even in the absence of interest rate risk, nondepository institutions such as SBLCs tend to sell guaranteed portions of 7(a) loans on the secondary market. We also note that SBA interest rate restrictions may reduce lender incentives to make fixed-rate loans because the restrictions preclude lenders from collecting higher interest rates from borrowers willing to pay higher rates to avoid interest rate risk. Lenders are restricted to interest rates that do not exceed the prime interest rate plus 2.25 percentage points for loans with maturities of less than 7 years and the prime rate plus 2.75 percentage points for loans with longer maturities.

Prepayments by Residential Mortgage Borrowers Depend on Overall Interest Rates

Residential mortgage borrowers with fixed-rate mortgages tend to prepay loans when interest rates decline because they can reduce their monthly mortgage payments by refinancing at the lower rates. Other prepayment situations occur when a borrower sells a residence or, in the case of guaranteed or insured mortgages, when foreclosure action against a borrower generates a prepayment. However, most mortgage prepayments occur because of declining interest rates, such as in 1993, when a majority of mortgage originations were refinancings as interest rates declined. This form of prepayment is easier to forecast due to the presence of future interest rate forecasts and historic data on the relationship between interest rate movements and mortgage prepayments.

Prepayments by 7(a) Borrowers Depend on Business Performance

Prepayments for 7(a) loans are tied more to business performance than to the movement of interest rates in the general economy and, as a result, are not as predictable as mortgage prepayments. As with residential mortgage borrowers, 7(a) borrowers have an incentive to prepay their 7(a) loans when the opportunity to obtain loans at more favorable terms arises. However, the determining factors for these prepayment opportunities differ for 7(a) borrowers. As most 7(a) loans have variable interest rates, these rates decrease in tandem with declining interest rates in the economy. SBA 7(a) loans serve a wide variety of businesses and business owners who then experience varying levels of financial success. Those that experience financial success or establish good credit can prepay their 7(a) loans by obtaining conventional loans at more favorable rates from private market lenders. On the other hand, those that default trigger SBA guarantee payments to prepay the guaranteed portions of the loans. These forms of prepayment are more difficult to forecast than residential mortgage prepayments. This also shortens the period during which investors who paid premiums for 7(a) pool certificates will realize the higher yields they anticipated. As a result, whatever prepayment risk exists for investors in 7(a) pool certificates and pool securities, it is magnified for investors who pay premiums[29] on guaranteed pool certificates because they are less likely to recoup their premiums when borrowers prepay.

[29] Investors are willing to pay prices higher than the par value of the guaranteed portions backing guaranteed pool certificates when they expect to realize higher yields over the life of the loans backing the pool.

Lenders, Securities Issuers, and Investors Face Credit Risk in Secondary Markets Without Government Guarantees

When government guarantees covering loan payments are absent, lenders, issuers, and investors face credit risk because losses occur when borrowers default on their loan payments. Secondary market participants have developed methods to project expected cash flows and determine credit risk on a given pool of loans using lender, borrower, and loan characteristics. Lenders establish underwriting standards, which include maximum loan-to-value ratios and loan payment-to-income ratios. Other issuers, such as Fannie Mae and Freddie Mac, have their own established underwriting standards. To insure themselves against losses, issuers often require lenders to provide credit enhancements and borrowers to purchase mortgage insurance. However, such requirements could reduce lenders' incentives to sell their loans on secondary markets.

Lenders limit their own credit risk by establishing underwriting standards for the loans they make and developing relationships with borrowers. Because the performance of the individual borrower is especially important to the cash flows for business loans, relationships with borrowers, in addition to protections created through underwriting, are more important in assessing credit risk for business than residential mortgage loans.

Securities issuers establish practices intended to help ensure that lenders who sell their loans have incentives to limit credit risk on those loans. For example, lenders who provide credit enhancements share the credit risk with MBS issuers and investors. MBS issuers often reduce their exposure to credit risk by requiring borrowers to purchase private mortgage insurance from a mortgage insurance company. These companies, in turn, also establish underwriting standards.

The enterprises provide corporate guarantees for timely payment of principal and interest on MBS backed by single-family residential mortgage loans they purchase. Where the loan amount exceeds 80 percent of the value of the housing unit serving as collateral, they normally require borrowers to purchase private mortgage insurance. The enterprises generally do not require lender-provided credit enhancements on single-family mortgage loans they purchase. They estimate and manage their exposure to credit risk using techniques developed to estimate the value of housing collateral, loan-to-value ratios, borrower payment burdens, and the relationships between these variables and loan losses.

Private-label conduits[30] that purchase single-family residential mortgage loans not eligible for purchase by the enterprises follow some of the same practices as the enterprises. Private-label conduits provide guarantees for timely payment of principal and interest, but unlike the enterprises, they normally pass on some of the credit risk to MBS investors. Private-label conduits also rely on private mortgage insurance and use the same techniques as the enterprises to manage their exposure to credit risk. The conduits, however, use forms of credit enhancement, such as subordination, not normally used by the enterprises.[31] As previously mentioned, credit enhancement is used to maintain scheduled payments to investors if borrowers go into default or are late in making payments and to bring securities to investment-grade ratings, as they act to mitigate the investor's credit risk. Providing such loss protection comes at a price to the conduit, because net proceeds the conduit pays the lender will be lowered by the cost of providing the credit enhancement, thus lowering the lender's incentive to securitize the loans. In 1997, about one-third of nonconforming conventional mortgages were sold in the secondary mortgage market.

In 1997, about 11 percent of unguaranteed portions of 7(a) loans were sold in the secondary market[32] compared to about 32 percent of nonconforming loans sold in the secondary mortgage market. One reason given for the lack of development of unguaranteed 7(a) secondary market is the relatively high costs to secondary market investors and rating agencies for monitoring 7(a) lenders and borrowers to assess credit risks based on available data. These costs are exacerbated by loan heterogeneity, including the various forms of businesses financed. For example, the value of the business funded is largely determined by the performance of the business operators. In contrast, the value of a housing unit providing collateral for a residential mortgage loan can be determined with little regard to borrower characteristics.

[30] Private-label conduits are private firms that purchase loans and repackage them for sale as securities.

[31] Other forms of credit enhancement that have been used include bank letters of credit that guarantee payment of principal and interest due on an MBS if the conduit fails to do so and over-collateralization. In the latter form of credit enhancement, the MBS issuer provides mortgage loans in excess of the pool of loans securitized to absorb potential losses resulting from borrower default.

[32] Since sales of unguaranteed portions were authorized by SBA in 1992, $1.2 billion of unguaranteed portions have been sold, compared to over $63 billion in nonconforming loans sold in the secondary market in 1997 alone.

Investors Have Greater Ability to Estimate Risks in Residential Mortgage Secondary Markets

Due to a number of factors, investors have a greater ability to estimate risks in secondary markets for residential mortgage loans compared to 7(a) secondary markets. The most important factor we have identified is the greater homogeneity of residential mortgage loans backing each MBS, compared to that of 7(a) loans backing 7(a) pool certificates and securities. Investors' ability to estimate risk of securities backed by pools of loans is also affected by the availability of historical data on loan performance of similar loans under varying economic conditions and information provided to investors.

Features of Pools and the Availability of Certain Historical Data Affect Risk Estimates

Reliable estimates of prepayment rates and loan losses can be more easily attained when loan pools are geographically diverse, loans are relatively homogeneous, and historical data on prepayments of similar loans under varying economic conditions are available. The greater homogeneity of residential mortgage loans backing each MBS, compared to that of 7(a) loans backing 7(a) pool certificates, facilitates estimating investors' prepayment and credit risks. The presence of large, geographically diverse loan pools and large historic databases of residential mortgage loan performance experience on loans with common characteristics also facilitates estimating the prepayment risk of MBS investors relative to 7(a) secondary market investors. The low level of unguaranteed portions securitized to date reflects the difficulty of estimating prepayment and credit risks on heterogeneous loans.

Cash flows of residential mortgages with equivalent payment terms (e.g., 30-year fixed-rate, 15-year fixed-rate, or adjustable-rate payment terms) back each single-family MBS, and participants in the secondary market can analyze large historic databases of prepayment histories of residential mortgages. The Bond Market Association establishes benchmark prepayment rates based on historic experience. Securities dealers use historic databases and financial forecast models to estimate future prepayment rates on mortgage loans that back each MBS issuance, which they, in turn, relate to the Bond Market Association benchmarks. Geographic diversification of a loan pool backing an MBS issuance lessens the probability that an unexpected adverse change in economic conditions in any one part of the nation will have a large impact on the cash flows backing the MBS. Large databases with historic information on prepayments for loans with specific characteristics are not available for the 7(a) markets as they are in the secondary mortgage markets, which means that investors in 7(a) secondary markets cannot estimate their credit and prepayment risks as well as MBS investors can.

The heterogeneity (i.e., the wide variety of unique characteristics) of 7(a) loans lessens the ability of investors to estimate prepayment risk because the effects of some unique characteristics cannot be estimated. SBA 7(a) loans differ in collateral type and the type of business to which each loan is made. Even within each business category, the performance of small business loans is heavily affected by business-owner capabilities that are not captured in historic databases. In addition, when individual loan pools are relatively small the presence of a few loans with unique characteristics can have a relatively large impact on the prepayment experience of the loan pool. The presence of a large number of lenders making a relatively small number of loans can also affect prepayment risk estimation due to the presence of unique characteristics relating to lenders and their loan practices. As table 2 shows, each 7(a) guaranteed pool averaged 26 loans in contrast to 42 loans for each Ginnie Mae MBS issued in 1997.

Information Disclosed Can Also Affect Risk Estimation

Ginnie Mae requires that its MBS investors receive an offering statement that discloses the issuer--normally the lender--of the MBS, the maturity dates, the principal amount of loans in the pool, and loan characteristics, such as whether they are fixed- or adjustable-rate.[33] Each month, Ginnie Mae computes a factor number, based on the remaining principal balances reported monthly by MBS issuers, for each loan pool. These factors are used to determine the amount of the original principal that will remain outstanding after the next payments are made on the pooled loans. Ginnie Mae requires each approved issuer to apply for commitment authority to issue a maximum dollar of MBS. Determinations of commitment authority levels for the largest lenders are based on examinations of each lender's financial capacity and lending practices. Ginnie Mae guaranteed MBS are exempt from SEC registration and reporting requirements. (A discussion of the securities laws as they apply to the registration of the securities offer in the secondary markets in residential mortgages and SBA 7(a) loans appears in app. III.)

While private-label MBS are subject to SEC registration and reporting requirements, Fannie Mae and Freddie Mac MBS are exempt from these requirements. However, according to enterprise officials, information on the offering statements for Fannie Mae and Freddie Mac MBS parallels that provided by private-label conduits. In addition to details provided in

[33] Ginnie Mae has two guarantee programs for single-family MBS, Ginnie Mae I and Ginnie Mae II. In Ginnie Mae I, each securities issuer makes separate monthly payments directly to each securities holder. In Ginnie Mae II, a central paying and transfer agent collects payments from all issuers and makes a monthly consolidated payment to each securities holder for all of its Ginnie Mae II holdings. The Ginnie Mae II program provides a mechanism for issuance of MBS backed by multiple issuer loan pools. As of September 30, 1997, Ginnie Mae I accounted for over 70 percent of Ginnie Mae guaranteed single-family MBS.

Ginnie Mae offering statements, those provided by the enterprises and private-label conduits include the geographic distribution of housing units financed by loans in each pool, detailed description of loan characteristics, and detailed discussion of risk factors.

SBA 7(a) pool certificates are also exempt from SEC registration and reporting requirements. SBA requirements for information provided investors in 7(a) pool certificates are somewhat similar to Ginnie Mae information requirements for its guaranteed MBS. SBA requires that 7(a) pool certificate investors be provided information on interest rate, maturity date, and aggregate original pool principal amount, as well as the pool certificate's estimated constant prepayment rate[34] and the loan pools used in determining the rate. SBA's fiscal and transfer agent provides monthly factor tables similar to those provided for Ginnie Mae. SBA officials told us that dealers can provide information on pool certificates they resell to other investors, but that in many instances such ongoing information on loan pools, such as which loans in a pool have been paid off, is not available to investors.

Because unguaranteed 7(a) pool securities are not backed by the SBA guarantee and are not considered agency securities, they are subject to SEC registration and reporting requirements.[35] Information provided on the prospectuses for public offerings that we reviewed included investment risks; the number of loans in a pool; the states where the loans were originated; and loan maturities, forms of loan collateral, and interest rates. However, the small volume in this secondary market reflects the negative impact of loan heterogeneity on the share of loans sold in this secondary market.

SBA officials told us that they are currently considering proposals for expanding information the agency makes available to investors in 7(a) pool certificates. For example, they told us that they are considering disclosing information such as the state where a small business is located and the industry in which it operates. Officials said that they are willing to consider providing such information now that the average number of loans backing each pool has grown from 18 in 1992 to 26 in 1997. In larger pools, such information is less likely to reveal the identity of individual borrowers

[34] A constant prepayment rate is the return rate at which the investor can expect to receive payments on the cash flow from the pool of loans backing the security.

[35] Information disclosed in the private placement issuance of unguaranteed 7(a) securities can differ from public offerings. We did not analyze 7(a) pool securities or MBS issuance electing the private placement exemption.

and expose them to potentially burdensome investor inquiries. The officials told us that such disclosures could negatively affect loan marketing for loans in locations and industries that may be construed as having relatively large prepayment risk. SBA officials told us that, while they had previously considered introducing fixed-rate loans with prepayment penalties and relaxing interest rate ceilings on fixed-rate loans, they believed that such changes would result in smaller pool sizes that could negatively affect prepayment risk diversification.

Table 2: Characteristics of the Guaranteed 7(a) and Ginnie Mae Secondary Markets

Characteristic	Guaranteed 7(a) Market	Ginnie Mae MBS Market
Average number of loans per pool issued in 1997	26	42
Number of lenders servicing loans in secondary market in 1997	1,540	354
Average number of pooled loans per lender in 1997	8	2,874
Individual lender /issuer limits on maximum level of loan sales	No volume limits are placed on poolers of 7(a) loans.	Every approved issuer must apply for commitment authority to issue a specified maximum dollar amount of MBS.
Minimum number of loans in pool	4	8
Minimum aggregate principal amount in a single loan pool	$1 million	$1 million
Maximum percentage of aggregate principal that can be accounted for by any single loan	25%	20%
Maximum range of interest rates	The loan with the highest interest rate can be no more than 2 percentage points above loan with the lowest interest rate.	Loans in a single lender pool must all have the same interest rate; interest rates on loans in a multi-lender pool must be within 1 percentage point of each other.

Sources: SBA and Ginnie Mae.

Fees Per Dollar of Loan Are Lower in the Residential Mortgage Than the 7(a) Secondary Markets

Over $500 billion in MBS guaranteed by Ginnie Mae is currently outstanding. Ginnie Mae approved lenders issue MBS backed by cash flows from federally insured residential mortgages. Ginnie Mae's fee of 6 basis points covers its guarantees for timely payment of principal and interest on these securities and pays for business expenses; default losses not covered by primary mortgage insurance; and contractual payments to business firms that provide processing, payment, and transfer services. Lenders that issue Ginnie Mae guaranteed MBS can retain 44 basis points of outstanding principal balance for servicing the mortgage loans.

Therefore, the interest rate spread between the interest rate paid by the borrower and received by the MBS investor is about 50 basis points.

More than $1.3 trillion in MBS guaranteed by Fannie Mae and Freddie Mac was outstanding as of June 30, 1998. Most single-family residential mortgages purchased by the enterprises are conventional mortgages without federal insurance. Guarantee fees charged by the enterprises average about 20 basis points per loan. With these fees, the enterprises cover default losses; business expenses; and payments to contractors for processing, payment, and transfer services. According to a Fannie Mae official, lenders who sell residential mortgages to the enterprises are allowed to retain, on average, about 30 basis points of outstanding principal balance for servicing the mortgage loans.[36] Therefore, the interest rate spread between the interest rate paid by the borrower and received by the MBS investor is approximately 50 basis points.

About $10 billion in 7(a) pool certificates is currently outstanding. SBA 7(a) lenders sell their loans to pool assemblers who form pools by combining loans from various lenders and then sell certificates backed by these pools. Colson Services, SBA's fiscal and transfer agent, monitors and handles the paperwork and data management system for all 7(a) guaranteed portions sold on the secondary market and serves as a central registry for all sales and resales of these portions. Lenders pay Colson 12.5 basis points of the certificates' value for the firm's secondary market services on guaranteed portions under its management. This cost, relative to Ginnie Mae's entire 6 basis point fee suggests that large volumes of activity generate economies of scale in the provision of functions such as processing, payment, and transfer services.

SBA does not limit the amount of servicing fees that lenders can retain on guaranteed portions of 7(a) loans they sell. Lenders' servicing fees generally range from 100 to 300 basis points. According to Colson officials, lenders who collect servicing fees in the lower portion of this range are more likely to sell their loans at a premium. As lenders use servicing fees, in part, to compensate for the credit risk they incur from the unguaranteed portions of 7(a) loans, these servicing fees are not comparable to servicing fees retained by residential mortgage lenders.

[36] The lower servicing fee for conventional, in comparison to FHA-insured, mortgages could reflect the impacts of more intensive servicing requirements or contracting arrangements for FHA-insured mortgages.

MBS Are More Liquid Than 7(a) Pool Certificates and Securities

A financial market is more liquid if market participants can buy, sell, and resell large amounts of holdings without affecting the prices of traded securities. In 1997, the dollar amount of resold Ginnie Mae guaranteed MBS was more than twice that of newly issued Ginnie Mae MBS, while in the 7(a) certificate market resales accounted for just over a third as many sales as newly issued certificates. Based on this evidence and discussions with SBA officials, we have concluded that Ginnie Mae guaranteed MBS and MBS issued by the enterprises and private-label conduits are more liquid than 7(a) pool certificates and securities. The homogeneity of single-family mortgage loans and the availability of a large historical database of information on them allow MBS investors to better estimate cash flows and risks than investors in 7(a) loans. Also, federal insurance and the timely payment guarantee eliminate credit risk to the investor in Ginnie Mae guaranteed MBS. While SBA’s timely payment guarantee on pool certificates aids liquidity, the problems inherent in estimating prepayment risk on 7(a) loans because of their heterogeneity hinder liquidity. The relative lack of available information on resold pool certificates, compared to newly issued certificates, also limits liquidity on resales.

While we lack resale statistics for private-label MBS, enterprise officials have told us that there is a lower level of liquidity in the nonconforming secondary mortgage market than in the conforming market. Credit risk in both the nonconforming secondary market and that for unguaranteed 7(a) pool securities can hinder liquidity. However, because of the added difficulty in estimating credit risk on heterogeneous loans, this factor is likely greater for investors in unguaranteed 7(a) pool securities. In addition, most 7(a) pool securities have been private placements, which by definition are less liquid investments.

Conclusions

By linking borrowers and lenders in local markets to national capital markets, secondary markets benefit lenders, borrowers, and investors. The share of loans in a primary market that is sold in a secondary market depends on the benefits that particular secondary market generates. The benefit to individual lenders of selling loans in a secondary market depends, in part, on demand for that lender's loans and the availability and costs of the lender’s alternative funding sources. Other considerations include whether holding loans on the balance sheet or selling them in the secondary market brings higher returns on invested capital and/or lowers the lender’s risks. Secondary markets also allow nondepository lenders, who cannot provide permanent financing to hold loans, to compete in primary loan origination markets.

In 1997, about $2.7 billion in guaranteed portions and about $290 million in unguaranteed portions of 7(a) loans were sold in the two respective secondary markets, representing about 45 and 11 percent, respectively, of originations that year. Lenders participating in these markets can reduce funding costs, and they can pass along some of their savings in the form of more favorable loan terms to borrowers. However, both 7(a) secondary markets lack certain attributes that permit reliable statistical risk analysis. The most important factors relate to primary market characteristics of 7(a) loans. With recent growth in the 7(a) guaranteed market and in the number of loans in each loan pool, SBA is considering proposals to expand information disclosed to investors in 7(a) pool certificates.

SBA has recently promulgated a rule, effective April 12, 1999, regarding sale of unguaranteed portions of 7(a) loans on the secondary market. SBA is concerned that such secondary market sales could reduce lender incentives to follow prudent lending standards and thereby increase risk to SBA. SBA is also concerned about the concentration of credit risk to the agency that could result from an active unguaranteed secondary market, which could increase the share of 7(a) loans accounted for by a small number of large lenders.

The guaranteed and unguaranteed secondary markets in 7(a) loans are smaller and less active than residential mortgage loan secondary markets, and a smaller share of loans from the primary markets are sold in the 7(a) secondary markets. Variances in the shares of loans sold in these secondary markets reflect certain factors in the primary and secondary markets. Notable factors affecting these secondary market outcomes include the relative (1) preponderance of fixed interest rates in the residential mortgage market, (2) homogeneity of loan characteristics among loans contained in each loan pool in that market, and (3) ability of residential mortgage market investors to evaluate the risks associated with each loan pool. These factors affect lenders' incentives to sell loans to mitigate interest rate risk, aid poolers in assessing loan characteristics, and assist investors in estimating their risks. Differences in the 7(a) markets lower the benefits provided by the 7(a) secondary markets compared to the secondary mortgage market and therefore the incentives to participate in these markets.

SBA will continue to face a number of challenging issues in the administration of the two secondary markets for 7(a) loans. As an example, uncertainties are present in the future development of the unguaranteed secondary market for 7(a) pool securities. This secondary market could (1) continue to be small largely as a result of loan

heterogeneity, (2) allow nondepository institutions to grow with an associated possible increase in competition in the primary 7(a) market, or (3) increase concentration risk to the 7(a) guarantee program.

Agency Comments and Our Evaluation

SBA's Associate Deputy Administrator for Capital Access provided written comments on a draft of this report, which are summarized below and reprinted in appendix IV. SBA also provided technical comments that were incorporated into the report where appropriate. Ginnie Mae also provided technical comments that were incorporated into the report where appropriate.

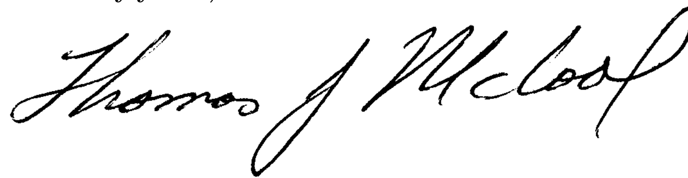
SBA's comment letter stated that the report fairly represents that the activity level in the secondary market for either the guaranteed or unguaranteed portion of Section 7(a) loans is a function of lender liquidity and/or lender structure. It also pointed out that since our 1998 report on SBA oversight was issued, SBA has performed oversight reviews of all of its preferred lenders and that the Farm Credit Administration, under an agreement with SBA, has completed the on-site portions of SBLC safety and soundness reviews. SBA noted that its headquarters is in the final editing stages of a lender oversight system to be used by both headquarters and field office staff for reviewing 7(a) lenders. SBA also stated that it has established a risk management committee that uses computerized data to manage the portfolio.

We have not evaluated these initiatives, but they appear to be the type of actions that could mitigate credit risk to SBA resulting from lender concentration.

We are sending copies of this report to Senator Christopher Bond, Chairman, and Senator John Kerry, Ranking Minority Member, Senate Committee on Small Business; Representative James Talent, Chairman, and Representative Nydia Velazquez, Ranking Minority Member, House Committee on Small Business; Representative Danny Davis, Ranking Minority Member, Government Programs and Oversight Subcommittee, House Committee on Small Business; The Honorable Aida Alvarez, Administrator, Small Business Administration; and other interested parties. Copies will also be made available to others upon request.

Please call me or Bill Shear, Assistant Director, at (202) 512-8678 if you or your staff have any questions concerning the report. Other major contributors to this report are listed in appendix V.

Sincerely yours,



Thomas J. McCool
Director, Financial Institutions
and Markets Issues

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Abbreviations

CPR	constant prepayment rate
CUSIP	Committee on Uniform Securities Identification Procedures
Fannie Mae	Federal National Mortgage Association
FHA	Fair Housing Act
Freddie Mac	Federal Home Loan Mortgage Corporation
Ginnie Mae	Government National Mortgage Association
HUD	Department of Housing and Urban Development
MBS	mortgage-backed securities
OFHEO	Office of Federal Housing Enterprise Oversight
SBA	Small Business Administration
SBLC	Small Business Lending Corporation
SEC	Securities and Exchange Commission
SPV	special purpose vehicle
VA	Department of Veterans Affairs

The Unguaranteed 7(a) Secondary Market

This appendix discusses aspects of the unguaranteed 7(a) secondary market, including its size and development, and how securities backed by unguaranteed portions of 7(a) loans are issued. It also discusses the disclosure requirements that pertain to issuance of the securities. Finally, it discusses regulatory and market mechanisms in the 7(a) secondary market that help ensure the safety and soundness of the SBA 7(a) program.

The Unguaranteed 7(a) Secondary Market Is Newer and Smaller Than the Guaranteed 7(a) Secondary Market

The secondary market for unguaranteed portions of SBA 7(a) loans is newer and smaller than that for the guaranteed portions. SBA first authorized the sale of unguaranteed portions of 7(a) loans on the secondary market in 1992, 8 years after pooled guaranteed portions were authorized to be sold. Recognizing that nondepository institution lenders lack customer deposits to fund their 7(a) lending, SBA initially allowed only those lenders to securitize their unguaranteed portions. In 1997, about $290 million in unguaranteed portions of SBA loans were sold on the secondary market compared to $2.7 billion dollars[1] in guaranteed portions. As of December 31, 1998, 20 pools of unguaranteed portions totaling about $1.25 billion had been sold since the sales were authorized in 1992.

Generally, securitizations of small business loans without federal guarantees have been limited. According to biannual reports issued jointly by the Board of Governors of the Federal Reserve System and SEC,[2] based on bank call reports, the total of small business loans—loans of less than $1 million—held by domestically chartered commercial banks was about $370 billion as of June 30, 1998. The report also stated that less than $3 billion in nonguaranteed small business loans had been securitized as rated offerings through the first half of 1998. This total includes about $1.2 billion in securitized unguaranteed portions of SBA loans.

As discussed elsewhere in these reports, the securitization of small business loans is slowed by characteristics of those loans that inhibit analysis by rating agencies and investors. The loans are not homogeneous, underwriting standards vary across originators, and information on historical loss rates is typically limited. To the extent that it is cost effective, one or more credit enhancements can be included in each securitization transaction to compensate for these characteristics. Credit enhancements are payment support features that cover defaults and losses

[1] Nearly $2.6 billion of this was for pooled guaranteed portions, with the remainder for individually sold guaranteed portions.

[2] Report to the Congress on Markets for Small-Business- and Commercial-Mortgage-Related Securities, September 1996 and September 1998, submitted pursuant to section 209 of the Riegle Community Development and Improvement Act of 1994.

up to a specific amount on loans backing a security, thereby reducing investor need for costly loan-specific information. In other words, credit enhancements act to increase the likelihood that investors will receive interest and principal payments even in the event that full payment is not received on the underlying loans. However, the higher the level of credit enhancement needed to sell the securities, the lower the net proceeds from the sale of the securities and the weaker the incentive for lenders to securitize their loans.

Securitizations of unguaranteed portions of 7(a) loans may be limited, in part, by the relatively small number of lenders with sufficient loan volume to create pools to back the securities. According to Moody's Investors Service, pool size typically ranges from 250 to 2,000 loans. (Although SBA sets no minimum number of loans for these pools, the more loans there are in a pool, the less risky the securities backed by that pool tend to be. Less risk translates to lower credit enhancement requirements and therefore less cost for enhancement, resulting in more profit for the issuer.) SBA rules currently allow securitizing only pools of unguaranteed portions of 7(a) loans originated by a single lender; however, SBA's final rule, effective April 12, 1999, provides for case-by-case consideration of multiple-lender securitizations of unguaranteed portions as well. Also, prior to April 2, 1997, only nondepository institution lenders had been authorized to securitize those portions of the loans. Of the nine issuers to date, six are SBLCs.

Securitizations in the Unguaranteed 7(a) Market Could Increase

Several factors could lead to increased issuance of securities backed by the unguaranteed portions of SBA loans, as follows:

(1) larger portfolio size of some lenders due to the substantial growth of the SBA program in recent years;

(2) favorable performance of SBA securitizations to date;

(3) recent inclusion of depository lenders among those authorized to sell securities backed by unguaranteed portions;

(4) pending participation by loan conduits, which will enable the creation of multilender pools to support securitizations of unguaranteed portions, as in the secondary market for guaranteed portions. SBA will consider multilender securitization on a case-by-case basis, according to a final rule effective April 12, 1999; and

(5) ongoing improvements in understanding and underwriting small business loans, such as credit scoring,[3] which may help determine and manage credit risks and improve the design of securitizations based on small business loans.

7(a) Securities Are Issued in Private Placements or Through Public Offerings

A lender's unguaranteed portions of 7(a) loans are securitized through the pooling and sale of those portions to a bankruptcy-remote special purpose vehicle (SPV).[4] Securities backed by unguaranteed portions of 7(a) loan portions are issued and sold to investors in either a private placement or public offering. Investors receive an ownership interest in the right to receive the principal of the pooled unguaranteed portions with interest. The stream of interest and principal payments is divided, according to the structure of the securitization, into various classes, which give securities holders differing priorities to, and allocable interests in, such payment streams.

These offerings are assigned ratings by securities rating agencies. The most risk-averse investors look for an investment-grade rating[5] to be reasonably sure of getting reliable cash flows. Investors willing to take on more risk can invest in lower-rated offerings, which offer higher expected returns. According to SBA officials, investors in SBA unguaranteed portions are generally institutional investors such as banks, pension funds, and credit unions that typically are required to restrict their investments to those of investment grade. All 20 securitizations of unguaranteed portions as of December 31, 1998, were investment-grade rated.

Public Offerings of 7(a) Securities Must Meet SEC Requirements for Disclosure of Information

Securitizations offered for public sale must be registered with SEC and meet its requirements for disclosure of information relating to the securities. The Securities Act of 1933 (the Securities Act) and the Securities Exchange Act of 1934 (the Exchange Act) require securities' issuers to disclose information to help investors assess the risks of a particular, publicly traded security. The Securities Act specifies

[3] Credit scoring is an automated process by which information about an applicant is used to predict that applicant's likelihood of repaying a loan. It is predicated on the notion that, with a relatively small number of variables, the probability of default for a given applicant can be predicted fairly reliably. [Report to the Congress on the Availability of Credit to Small Business, October 1997, by the Board of Governors of the Federal Reserve System.]

[4] Historically, the sale of unguaranteed portions has been limited to single-lender pools, but SBA is considering a rule that would allow multilender pools.

[5] An investment grade rating is one of the top four ratings given by any of the four leading securities rating agencies—Moody's, Standard and Poor's, Duff and Phelps, and Fitch.

registration and disclosure requirements, and the Exchange Act requires continuing disclosure after a security is issued. The required disclosures are made in a prospectus or offering statement that is distributed in connection with the offer and sale of a security.

Privately Placed 7(a) Securities Are Exempt From SEC Requirements for Disclosure of Information

In a private placement, the issuer can avoid the costly registration and reporting process required of a public offering.[6] Administrative and judicial decisions provide the criteria for determining whether a transaction does not involve a public offering.[7] In addition, in order to minimize the uncertainty about reliance on the private offering exemption, SEC has a safe harbor rule exempting transactions that meet its requirements.[8] In general, private placements are less liquid than publicly traded securities.

Measured in Dollars, Public Offerings Accounted for Most Activity

Of the nine issuers of securities backed by the unguaranteed portion of 7(a) loans, as of December 30, 1998, one--The Money Store--issued publicly traded, registered securities, while the other eight have sold their securities through private placements. The Money Store accounted for 40 percent of the total 7(a) securities transactions as of December 31, 1998, and about two-thirds of the $1.25 billion total for all securitizations as of that date.

Securities Rating Agencies Help Determine How 7(a) Securities Are Structured

Securities rating agencies play an important role in determining how securities should be structured and priced to appeal to investors. To understand how securities rating agencies approach the rating of SBA loan-backed securitizations, we reviewed reports on this subject published by Moody's Investors Service and Standard and Poor's.[9] According to the reports, the agencies estimate the ability of a transaction to pay interest and principal fully and in a timely manner under varying levels of stress.

The agencies analyze historical performance data, including SBA loss performance studies of loans from common origination periods and portfolio data from specific lenders. If a loss curve cannot be developed

[6] 15 U.S.C. § 77d(2).

[7] Generally, the following criteria apply: (1) the offering must be made on a limited basis to selected persons and not pursuant to a general solicitation of the public; (2) the securities must be sold only to persons who are either sophisticated in business matters or able to obtain the type of assistance that will enable them to make informed investment decisions; and (3) prior to making the decision to buy, the purchasers must either be furnished with, or given access to, information that would be obtained through the registration process.

[8] See regulation D (17 C.F.R. § 230.501-08).

[9] Moody's Approach to Rating SBA Loan-Backed Securitization, Moody's Investors Service, March 29, 1996, and Securitization of Small Business Administration 7(a) Program Loans, Standard and Poor's, October 18, 1996.

for a specific originator due to lack of sufficient historical data, the SBA aggregate loss curve may be used to project losses for recently originated pools. Generally speaking, the more limited the data, the less precise the loan pool performance estimates can be, which requires a higher level of credit enhancements. Such factors as the age of the securitized loans in the portfolio, referred to as seasoning; the degree of industrial and geographic diversity of the loans in the pool; and the number of loans in the pool also play a role in loss performance analyses.[10]

In reviewing the originator's and servicer's operations to gain insight into the policies and procedures they use to originate, underwrite, and service the SBA loans, a rating agency might look at such areas as

- management and financial strength,
- credit origination and approval,
- servicing and collection practices,
- back-up servicing,
- workout and liquidation policies,
- environmental issues, and
- data processing and reporting.

The Moody's report states that the ultimate credit quality of a security depends not only on the riskiness of the underlying loans but also on the manner in which the transaction is structured to channel the benefits of payments from borrowers to investors.

All 7(a) Securities Have Used Subordination and Excess Spread As Credit Enhancements

As mentioned earlier, SBA 7(a) securities are usually structured in classes that provide differing streams of interest and principal payments, reflecting securities holders' differing priorities to, and allocable interests in, such payment streams. A typical two-class structure would have senior and subordinate classes, with the subordinate class typically providing protection against principal and interest shortfalls for the senior class after the exhaustion of funds set aside to provide such protection. The funds that are set aside to provide the protection come from excess spread[11]

[10] According to Moody's, "Because cumulative losses increase over time, a highly seasoned pool will have much lower remaining expected loss and variability than a similar, but less seasoned pool."

[11] Excess spread is the difference between the interest received on the SBA loan and the rate paid to the buyer of the securitized interest, after administrative fees have been deducted. A spread account is a cash account established and partially funded at transaction closing and built up through excess spread over time to a predetermined dollar amount. Once the spread account is fully funded, any amount deposited in excess of the required balance may be released to the seller or servicer. In the event of a draw on the spread account, amounts otherwise distributable to holders of subordinate securities are subsequently used to replenish the account.

from the sale of both the guaranteed and unguaranteed portions.[12] All securitizations of the unguaranteed portions of 7(a) loans done before June 30, 1998, have used subordination and excess spread from the sale of both the guaranteed and unguaranteed portions to enhance the securities. Although credit rating agencies gave subordinated classes lower investment grade ratings than the senior classes, subordinated classes offer higher returns to compensate for the added risks.

In order for securitization to be feasible, the interest received from the loans in the pool must exceed the sum of interest paid to security holders and the costs of organizing the securitization. The excess spread from the guaranteed portions and the spread generated from the sale of the unguaranteed portions have been used to enhance the credit for transactions where the unguaranteed portions are securitized. When the lender receives loan payments, it remits the portion of the payment on the unguaranteed portion, along with the excess spread (minus fees) to a collections account established by a trustee for the benefit of the investors. The trust uses these funds to make necessary payments, such as interest and principal on the securities, spread account deposits, and servicing fees. Should a default occur in the pool, the cash flows that would have come from the defaulted loan would be paid from the excess fund account until it is depleted.

In Approving 7(a) Securities, SBA Seeks to Ensure the Safety and Soundness of the 7(a) Program

Because unguaranteed portions lack the SBA guaranty, SBA involvement in the unguaranteed 7(a) secondary market is limited to ensuring that the safety and soundness of the 7(a) program are protected before it approves a securitization. SBA does not set minimum pool sizes or dictate the range of loan terms for loans in a pool of unguaranteed 7(a) loan portions as it does for pools of guaranteed portions. SBA establishes requirements for lenders who wish to sell their unguaranteed portions on the secondary market. In this section, we discuss existing and proposed requirements for securitization of 7(a) loans, which are intended to help ensure the safety and soundness of the 7(a) program.

[12] This form of credit protection creates a link between the two 7(a) secondary markets. The excess spread from the guaranteed portions that is used to cover credit losses from the unguaranteed portions serves to increase the yield spread between interest rates paid by borrowers on the loans and yield paid to investors on the unguaranteed pool securities.

Existing Requirements to Ensure the Safety and Soundness of the 7(a) Program

Before a lender can securitize a pool of unguaranteed portions of SBA 7(a) loans it originated, it must obtain SBA's written consent. To obtain this consent, the lender must satisfactorily show that it is retaining an economic risk in the unguaranteed portions—such as keeping a certain percentage of the unguaranteed portion or of the securitized pool backed by these portions. This risk-sharing requirement is intended to provide an economic incentive for lenders to maintain prudent lending practices. The lender must also meet other criteria in SBA rules for securitizing these portions.

To effect a securitization of unguaranteed portions that converts individual loans into several types of marketable securities, a lender must sell them to a legal entity, known as a special purpose vehicle, which issues securities that represent ownership in these portions. SBA rules require that the lender continue servicing a loan after the pledge or transfer is made. SBA rules also require that the lender, or a custodian agreeable to SBA, hold the loans. According to officials at Colson Services, Inc., the fiscal and transfer agent for SBA that collects payments on guaranteed portions from lenders and distributes the proceeds to investors in guaranteed pools, its role in the secondary market for unguaranteed portions is limited to holding the notes for SBA.

New Requirements to Ensure the Safety and Soundness of the 7(a) Program

As mentioned earlier, SBA initially allowed only its nondepository lenders to securitize their unguaranteed portions. This reflected SBA's recognition that nondepositories do not have customer deposits to fund their 7(a) lending. However, the October 1, 1996, Small Business Program Improvement Act of 1996 directed SBA to promulgate a final rule that applied uniformly to both depository and nondepository lenders, setting forth the terms and conditions and other safeguards to protect the safety and soundness of the program, or cease permitting the sale of the unguaranteed portion of 7(a) loans after March 31, 1997. After proposing a rule in February 1997, SBA promulgated an interim final rule on April 2, 1997, that extended the program to include depository lenders and set forth some terms and conditions while it continued its review of securitization issues. On February 10, 1999, the agency promulgated a final rule that became effective on April 12, 1999.

The rulemaking process included two proposed rules, two public hearings, and an interim rule as the agency took the time to consider views and comments of securitization and accounting experts, representatives of financial regulatory agencies, and industry representatives in drafting a final rule. A final rule, promulgated February 10, 1999, and effective April 12, 1999, generally requires that a securitizer

- have sufficient capital to meet the definition of “well-capitalized” used by bank regulators (depository institution), or maintain a minimum applicable capital equal to at least 10 percent of its assets, excluding the guaranteed portion of its 7(a) loans and including any remaining balance in its portfolio or in any securitization pool (nondepository institution);

- retain for 6 years a subordinated interest in the securities, the amount of which is the greater of two times the securitizer’s loss rate on its 7(a) loans disbursed for the preceding 10-year period or 2 percent of the principal balance outstanding at the time of the securitization of the unguaranteed portions of the loans in the securitization; and

- be placed on probation for one quarter, and then suspended for at least 3 months from preferred lender status if the securitizer’s default rate crosses certain thresholds and fails to improve to SBA’s standards. SBA also will not approve additional securitization requests from that securitizer during the suspension period.

The Guaranteed 7(a) Secondary Market

This appendix discusses aspects of the guaranteed 7(a) secondary market, including its size and development and how certificates backed by guaranteed portions of 7(a) loans are issued. It also discusses the disclosure requirements that pertain to issuance of the certificates.

The Guaranteed Secondary Market

The guaranteed secondary market was created in 1972, when the first guaranteed portions of individual loans were sold. In 1984, Congress authorized issuance of pool certificates backed by pools of the guaranteed portions. Lenders sell their loans to pool assemblers who form pools by combining the loans of several 7(a) lenders. Overall, about 88 percent of all loans sold in the secondary market in 1997 were pooled loans.

SBA Has Specific Requirements for Formation of Loan Pools Backing 7(a) Certificates

SBA prescribes certain characteristics that every pool of 7(a) guaranteed portions must meet. Each pool must have at least four loans with a minimum aggregate principal balance of at least $1 million. No single loan can account for more than 25 percent of the pool. Although all loans in a pool need not have the same interest rate, they must be either all fixed or all variable rate loans. If the pool has variable rate loans, all loans must have the same rate adjustment dates. The pool's interest rate is based on the loan with the lowest net interest rate,[1] and the range of these rates cannot be greater than 2 percent. The maturity date designation for the entire pool is based on the loan with the longest remaining term to maturity. The remaining term to maturity for the shortest loan in the pool must be at least 70 percent of that for the longest. New loans cannot be added to a pool to replace others that prepay or default. In calendar year 1997, 427 variable rate pools and 5 fixed rate pools were formed, averaging 25 and 9 loans per pool, respectively.

Pool Certificates are Based on Loan Pools

Pool certificates are issued on each pool in denominations of at least $25,000. Each pool certificate has a unique number, called a Committee on Uniform Securities Identification Procedures (CUSIP) number, for identification purposes.[2] They are backed by the full faith and credit of the U. S. government and have a timely payment guarantee from SBA. SBA does not charge for its timely payment guarantee,[3] which ensures that investors will be paid on scheduled dates regardless of whether payments from borrowers were on time. This timely payment guarantee applies only to pooled guaranteed portions of 7(a) loans, and not to individually

[1] Net interest rate is the rate of interest, net of fees, on an individual guaranteed portion.

[2] The CUSIP numbering system is used by the securities industry as a standard shorthand means of identifying securities. The CUSIP division of Standard & Poor's assigns these numbers.

[3] SBA charges lenders a guarantee fee for each 7(a) loan they originate, ranging from 2 percent to 3.875 percent of the amount of each loan.

purchased loans. As with other government guaranteed securities, these securities are exempt from SEC registration and reporting requirements.

Pool Assemblers Form Loan Pools and Issue Certificates

Pool assemblers acquire the guaranteed portions of SBA 7(a) loans from lenders, create the pools, and issue pool certificates through Colson Services Corp., SBA's fiscal and transfer agent. SBA must approve all pool assembler applicants. SBA criteria require applicants to be in good standing with SBA, any state or federal regulatory bodies that govern their activities, and the National Association of Securities Dealers, if members. They must meet certain net worth requirements and must have the financial capability to assemble acceptable and eligible loans in sufficient quantity to meet the requirements for issuing pool certificates. Federal- or state-chartered banks and savings and loan associations, insurance companies, credit unions, SBLCs, and broker-dealers can all become pool assemblers as long as they meet these requirements.

The Fiscal and Transfer Agent Has an Active Role With Pool Certificates

Colson Services Corp., based in New York City, is SBA's fiscal and transfer agent for secondary market transactions involving both individual 7(a) loans and pooled guaranteed portions. For each transaction, Colson issues a certificate and sets the beginning balance, interest rate, maturity, payment schedule, and issue date once it has determined that the issuer or seller has provided the necessary documents to support the transaction. Colson delivers the certificates to the registered holders (investors or their designee). Colson maintains a registry of registered holders and the current outstanding principal balance of each certificate. Borrowers pay lenders, who take out their fees and other portions of the payments due them and forward the remainder to Colson. Colson then makes principal and interest payments to the registered holders. It also sends statements to registered holders on the status of each pool backing their certificates. When a pooled loan prepays or defaults, Colson forwards each registered holder its pro rata share of the prepayment or SBA's guaranty purchase. Colson's fee is one-eighth of 1 percent of the outstanding balance per year for its services, which it collects by retaining a portion of the lender's payments.

SBA Has Disclosure Requirements for Both Guaranteed Pool Certificates and Individual Loan Certificates

SBA requires the seller to disclose certain information to the buyer before all initial sales and subsequent sales (transfers) of guaranteed pool certificates and individual loan certificates. The seller must disclose a yield calculation and the prepayment rate assumptions on which the yield calculation is based; the scheduled maturity date; the price to be paid by the buyer, both in dollars and as a percentage of the par or principal loan amount; the dollar amount of premium or discount associated with the sale price; and the interest rate (the base rate and the differential for

variable rate loans). The seller must also disclose investment characteristics, such as the fact that (1) SBA guarantees timely payment of principal and interest on pool certificates, but not on individual loan certificates; (2) SBA will purchase the guaranteed portion of individual loans after 60 days of default by the borrower; (3) SBA does not guarantee premiums paid for certificates; and (4) the loan or pool may be prepaid prior to the maturity date.[4]

Through its disclosure requirements, SBA seeks to provide investors with an annual constant prepayment rate (CPR) based on the seller's analysis of the prepayment histories of SBA guaranteed loans with similar maturities and with information on the certificates' terms, conditions, and yields. Colson provides a summary report of CPRs of pools with similar maturities, which is attached to each guaranteed pooled certificate issued. Investors can compare the CPRs represented by their seller with that reported for similar sales. Colson updates the summary information each month on a rolling 6-month basis. SBA officials believe this system keeps the CPR information current and useful to investors and other market participants. SBA guaranteed certificates are generally marketed to institutional investors, such as pension funds and insurance companies.

SBA has authorized Colson to make available to subscribers a data tape containing the payment history of every SBA 7(a) loan sold since 1985, the time Colson has functioned as fiscal and transfer agent. To maintain borrower confidentiality, Colson eliminates identifying loan numbers and zip codes and provides a dummy number for each loan.

Broker-Dealers Selling Guaranteed Portions Must Meet Certain Requirements

Individuals or organizations must meet certain requirements before they are permitted to act as brokers or dealers in initial sales or transfers of guaranteed certificates on either individual loans or pooled loans. They must be regulated by a state or federal financial regulatory agency or SBA, or be a member of the National Association of Securities Dealers.

Lenders Service Loans After Selling Them on the Secondary Market

SBA regulations require lenders to retain responsibility for all loan-servicing activities, including those for loans sold in the secondary market. SBA regulations allow lenders to earn fee income for servicing its small business loan portfolio when the guaranteed portions have been sold in the secondary market. By retaining servicing responsibilities, lenders can also maintain long-term relationships with their customers. A lender services its loans by continuing to collect principal and interest payments from borrowers and managing the collateral. The lender must forward monthly

[4] A buyer may prepay a SBA 7(a) loan at any time without penalty.

payments from borrowers to Colson along with a complete accounting of the funds.

SBA Guaranteed Pool Certificates and Ginnie Mae MBS Are Exempt From SEC Registration and Reporting Requirements

The Securities Act of 1933 (the Securities Act) and Securities Exchange Act of 1934 (the Exchange Act) require securities issuers to disclose information to help investors assess the risks of a particular publicly traded security. The Securities Act specifies registration and disclosure requirements. The required disclosures are contained in a prospectus or offering statement that is distributed in connection with the offer and sale of a security. The Exchange Act requires continuing disclosure after a security is issued. Certain publicly traded securities are exempt from the registration and reporting requirements of the Securities Act[1] as well as from the continuing reporting requirements of the Exchange Act. For example, securities issued or guaranteed by the United States, its agencies, and corporate instrumentalities are exempt. Offerings of exempt securities, however, are subject to the antifraud provisions of the federal securities laws, which provide generally that offering materials shall not contain an untrue statement of a material fact in connection with the offer or sale of a security.[2]

This exemption includes securities guaranteed by SBA and Ginnie Mae as well as securities issued by most government-sponsored enterprises, such as Fannie Mae and Freddie Mac. The sale of the guaranteed portions of 7(a) loans in the secondary market also is exempt from these provisions in the Securities Act and the Exchange Act because of SBA's unconditional guarantee. SBA provides investors an unconditional guarantee to pay principal and interest, including interest accrued to the date SBA honors its guarantee, on the guaranteed portion of each 7(a) loan that goes into default. Pooled certificates also contain a timely payment guarantee from SBA to make scheduled payments to investors in the event of default.

SBA, Ginnie Mae, Fannie Mae, and Freddie Mac all issue or guarantee exempt securities that are sold in different types of offerings. For example, SBA pooled certificates typically are backed by up to 25 SBA-guaranteed loan portions and marketed by pool assemblers to a small number of institutional investors. Investors in SBA-guaranteed securities receive required disclosures on the terms, conditions, and yield of the pool that they are purchasing. For example, with regard to prepayment risk information, the fiscal and transfer agent tracks and provides a summary report of constant prepayment rates (CPR) of similar maturities, which is to be attached to each guaranteed pooled certificate issued. Ginnie Mae

[1] For an instrument to be exempt from registration, it either must constitute an exempt security, be sold in an exempt transaction, or not be classified as a security.

[2] The pools of guaranteed portions also are exempt from registration under the Investment Company Act of 1940. See SEC No-Action Letter, 87-210-CC (April 13, 1987).

guaranteed MBS are backed by larger mortgage pools and sold in public offerings to a large investor market. The offering materials for Ginnie Mae securities includes the issuer, the principal amount of loans in the pool, whether the loans backing the pools are fixed- or adjustable-rate, the interest rate, and the maturity date. Fannie Mae and Freddie Mac MBS are typically issued in public offerings in which investors receive offering materials that contain detailed information about the loan pools. According to enterprise officials, the information provided by Fannie Mae and Freddie Mac is similar to that provided by MBS issuers who are not exempt from SEC registration and reporting requirements.

With regard to the securitization of the unguaranteed portion of 7(a) loans, an SBA lender may issue a security that is backed by the cash flows from the unguaranteed portions. These securities are not covered by the same exemption as the guaranteed portion securitizations because an SBA guarantee is not present. Accordingly, when these securities are publicly offered and traded, they are subject to SEC registration and reporting requirements. Therefore, issuers are required to comply with registration and reporting requirements in the federal securities laws unless they rely on another exemption from registration, such as the private placement exemption. In a private placement, the issuer can avoid the costly registration and reporting process if the transaction by the issuer does not involve a public offering.[3] Administrative and judicial decisions provide the criteria for determining whether a transaction does not involve a public offering.[4] In addition, in order to minimize the uncertainty about the reliance on the private offering exemption, SEC has a safe harbor rule that provides more objective standards. If the rule is properly followed, the issuer is assured the availability of the exemption.[5] Many corporate securities issuers use the private placement market. One of the characteristics of a private placement, however, is that the investor cannot easily resell the security; that is, the security is less liquid than a publicly traded security. Of the nine issuers to date of securities backed by the unguaranteed portion of 7(a) loans, one has issued publicly traded,

[3] 15 U.S.C. §77d(2).

[4] Generally, the following criteria apply: (1) the offering must be made on a limited basis to selected persons and not pursuant to a general solicitation of the public; (2) the securities must be sold only to persons who are either sophisticated on business matters or able to obtain the type of assistance that will enable them to make informed investment decisions; and (3) prior to making the decision to buy, the purchasers must either be furnished with, or given access to, information that would be obtained through the registration process.

[5] See regulation D (17 C.F.R. §230.501-08). Regulation D permits the sales of interest to an unlimited number of accredited investors (as defined in rule 501) but limits sales to 35 or fewer nonaccredited investors.

registered securities, while the other eight have sold their securities through private placements.

Comments From the Small Business Administration

U.S. SMALL BUSINESS ADMINISTRATION
WASHINGTON, D.C. 20416

April 14, 1999

Mr. Thomas J. McCool
Director, Financial Institutions and Market Issues
United States General Accounting Office
General Government Division
Washington, DC 20548

Dear Mr. McCool:

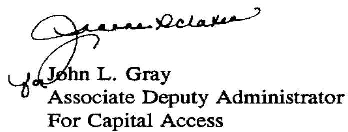
Administrator Alvarez asked me to respond to your letter regarding the draft of the report entitled "Size of the SBA 7(a) Secondary Markets is Driven by Benefits Provided". We appreciate the opportunity to review the draft. We believe the report describes fairly the fact that the level of activity in the secondary market for either the guaranteed or unguaranteed portion of Section 7(a) loans is a function of lender liquidity and/or lender structure. The report notes that many lenders in the SBA program have alternative sources of funds and do not depend on the secondary market to the same extent as providers of credit to the residential mortgage market.

We do believe, however, that the references in the report to the status of SBA's review of Lenders on pages 4, 19, and 27, should be updated. There, the report refers to weaknesses in SBA's oversight activities that were described in a previous GAO report. SBA has taken significant steps to improve the oversight of participating lenders. The SBA began its first cycle of Preferred Lender Program (PLP) lender reviews in May, 1998. This first cycle included reviews of all PLP participant lenders that had made at least one PLP loan in fiscal year 1997. As of March 31, 1999, SBA had completed its reviews of the 276 PLP lenders included in the first review cycle. This is an ongoing process and SBA is starting the second cycle of PLP reviews this month. Starting in September 1998 the Farm Credit Administration (FCA), under an agreement with SBA, performed a safety and soundness review of all 14 Small Business Lending Companies (SBLC). FCA has finished the on site portion of the review and will be completing a report to SBA in the near future. SBA will use this report to assess the safety and soundness of the operations of the SBLCs. SBA Headquarters is in the final editing stages of a lender oversight system to be used by SBA employees in Headquarters and the field offices to use to review lenders in both the 7(a) and 504 program. Finally, SBA has established a risk management committee that uses available computerized data to manage the portfolio.

We believe inclusion of this information in the report will give the reader a more complete and up to date picture of the status of lender oversight at SBA.

If you need further information, please let me know.

Sincerely,



John L. Gray
Associate Deputy Administrator
For Capital Access

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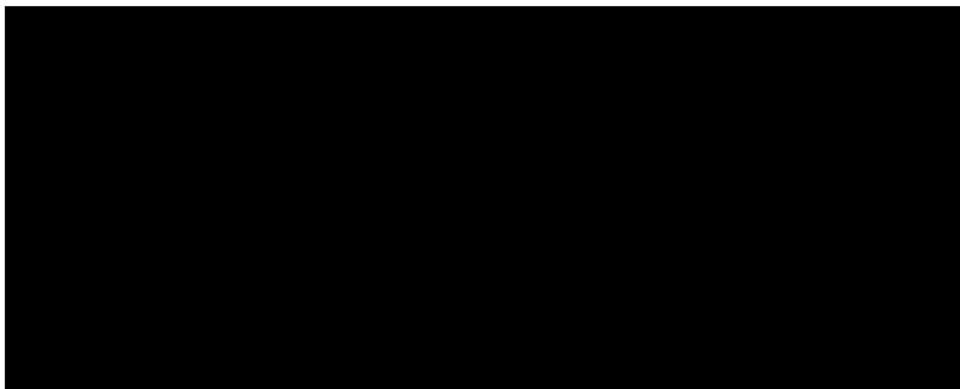

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