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SMALL BUSINESS ADMINISTRATION

Secondary Market for Guaranteed Portions of 7(a) Loans

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Statement

Small Business Administration: Secondary Market for Guaranteed Portions of 7(a) Loans

Mr. Chairman and Members of the Subcommittee:

I am pleased to be here today to discuss preliminary results of our ongoing review of the secondary market in Small Business Administration (SBA) 7(a) loans. Under the program, SBA guarantees to repay a participating lender a prespecified percent of the amount of the 7(a) loan in the event of borrower default. Guaranteed and unguaranteed portions of 7(a) loans are sold in separate secondary markets. Mr. Chairman, you requested that we review both the guaranteed and unguaranteed secondary markets in 7(a) loans. For the purposes of today's hearing, I will limit my focus to the 7(a) secondary market for the guaranteed portion. My statement has three objectives. The first is to discuss the benefits generally provided by secondary loan markets. The second is to describe characteristics of the secondary market for federal government guaranteed mortgage loans. In particular, in our review we are focusing on the market for mortgage-backed securities (MBS) guaranteed by the Government National Mortgage Association (Ginnie Mae). The third objective is to describe the characteristics of the guaranteed 7(a) secondary market in relation to those of the Ginnie Mae MBS secondary market. In conducting our ongoing analysis on both the guaranteed and unguaranteed portions of 7(a) loans, we are paying particular attention to identifying actions that indicate the potential to improve the efficiency of the SBA secondary market in achieving the objectives established for it.

Secondary loan markets link borrowers and lenders in local markets to national capital markets, thus reducing dependence on local funds availability. The secondary market in residential mortgages is recognized for creating this link. This secondary market has reduced regional imbalances in the availability of loanable funds. Other benefits, which include tapping additional sources of funds, have also helped to lower interest rates paid by borrowers. In addition, this secondary market allows interest rate risk inherent in holding fixed-rate loans to become diversified among investors that might be better able to hedge against such risks than loan originators. Our preliminary results indicate that the guaranteed 7(a) secondary market has also linked borrowers and lenders in local markets to national capital markets, and thus generated some of the benefits generally created by other secondary markets. However, the guaranteed 7(a) secondary market has characteristics that limit its size in relation to the primary 7(a) market. In particular, most 7(a) loans are variable-rate loans with almost no interest rate risk, which reduces incentives for some lenders to use the secondary market. In addition, 7(a) secondary market investors, relative to MBS investors, have less information to accurately

estimate their exposure to risks associated with borrowers paying off their loans before they are due (prepayment risks), which may limit whether or how much they are willing to participate.

To meet the objectives of my statement, we reviewed SBA's standard operating procedures for its 7(a) program, rules and regulations for the guaranteed 7(a) secondary market, and other SBA documents addressing the role of this market. We reviewed studies on the secondary markets in 7(a) guaranteed loans and residential mortgage loans conducted by numerous federal agencies and other parties. We obtained and analyzed data from SBA and the Department of Housing and Urban Development (HUD). We also interviewed representatives from SBA, HUD, Colson Services (the program's fiscal and transfer agent), financial industry regulators, industry associations, and various 7(a) lenders and poolers.

Background

The 7(a) loan program, SBA's largest lending program, is intended to serve small business borrowers who cannot otherwise obtain financing under suitable terms and conditions from the private sector. Under the program, SBA guarantees to repay a participating lender a prespecified percentage of the 7(a) loan amount (generally between 75 and 80 percent) in the event of borrower default. To obtain a 7(a) loan guarantee, a lender must document that the prospective borrower was unable to obtain financing under reasonable terms and conditions through normal business channels. Borrowers participating in the program represent a broad range of small businesses, including restaurants, consumer services, professional services, and retail outlets.

The dollar volume of 7(a) loans that can be guaranteed under SBA's authority is predetermined each fiscal year by congressional appropriations that subsidize the program. During fiscal year 1997, 7(a) loan approvals totaled nearly $9.5 billion—the highest level of loan approvals in the program's history and an increase of over 20 percent from the previous fiscal year. As of December 31, 1997, there was $21.5 billion in total 7(a) loans outstanding.

About 8,000 lenders are approved to participate in SBA's 7(a) program. They range from institutions that make a few 7(a) loans annually to more active institutions that originate hundreds annually. Most of the lenders are insured depository institutions such as banks and thrifts. Among nondepository lenders active in the 7(a) program are 14 Small Business

Lending Companies (SBLC) that accounted for about 19 percent of 7(a) loans outstanding at the end of 1997.

Secondary Loan Markets Generate Benefits

A secondary loan market is a resale market for loans originated in the primary market. It allows a lender to sell a loan it originates rather than holding the loan on its balance sheet. To hold a loan on its balance sheet, the lender would be required to obtain funding for the time period over which the loan was outstanding. For the types of loans I am discussing, when a lender sells a loan, it continues to service the loan by collecting borrower principal and interest payments and taking possible corrective actions if the borrower does not make required payments. A number of benefits are associated with secondary markets. They provide lenders a funding alternative to deposits, lines of credit, and other debt sources. Secondary loan markets generally link borrowers and lenders in local markets to national capital markets, which can provide liquidity for lenders and thereby reduce regional imbalances in loanable funds and possibly increase the overall availability of credit to the primary market and lower interest rates for borrowers.

The share of loans in a primary market that are sold in a secondary market depends on the benefits generated by the secondary market. For example, secondary markets allow interest rate risk to be diversified among investors with access to funding sources that help them manage such risks. Interest rate risk is the possibility of financial loss due to changes in market interest rates. This risk is greatest for holders of assets such as fixed-rate loans. For example, a financial institution holding a 30-year fixed rate mortgage on its balance sheet that it funds with short-term liabilities can experience losses if interest rates rise. In this case, interest earnings from the mortgage do not increase while interest costs do. Interest rate risk is also present for variable rate loans with caps that limit how much interest rates paid by the borrower can increase. Adjustable-rate residential mortgages are an important example of such a variable-rate loan product. Depository institutions that rely on short-term deposits for funding have incentives to avoid holding fixed-rate assets on their balance sheets. In this case, secondary markets provide a funding source that is less likely to be disrupted in a changing interest rate environment.

Other loan risks, such as credit risk and prepayment risk, can limit benefits and subsequently the share of loans sold in a secondary market. Credit risk is the possibility of financial loss resulting from borrower

defaults. When secondary market investors are exposed to credit risk, secondary market sales can be impeded if investors lack information on lenders, borrowers, and loan characteristics to estimate their exposure to credit risks. Investors who purchase federally guaranteed loans and securities are not subject to credit risk because the federal guarantees ensure that investors will be paid on defaulted loans. However, lenders and investors are subject to credit risk on unguaranteed loans or portions of loans.

Prepayment risk is the risk that borrowers will pay off their loans before maturity. For example, prepayments can lower returns to investors in fixed-rate loans if borrowers prepay the loans when interest rates decline. Likewise, for fixed- or variable-rate loans, prepayments can lower returns to investors who pay a premium for a pool of loans with relatively high interest rates. Federal guarantees do not mitigate this risk. Thus, secondary market sales can be impeded if investors lack information on lenders, borrowers, and loan characteristics to estimate their exposure to prepayment risks. Analysts are able, by using various statistical techniques, to estimate prepayment risks for large loan pools for which information is available on the pool's loan characteristics and historic prepayment rates on statistical samples of similar loans. In contrast, such estimates are less reliable for securities backed by loan pools composed of a relatively small number of loans. The size of the pool is important because loans with cash flows that represent statistical outliers are less likely to cause the cash flow from a large pool to differ from those of other representative statistical samples of similar loans.

The Ginnie Mae Guaranteed MBS Market Is Large

Ginnie Mae is a government corporation that is part of the Department of Housing and Urban Development. Ginnie Mae participating lenders originate mortgages insured by the Federal Housing Administration (FHA) and the Department of Veterans Affairs (VA) for resale in the secondary market. These lenders issue mortgage-backed securities backed by cash flows from these mortgages. For a fee of 6 basis points[1], Ginnie Mae guarantees timely payment of principal and interest on these securities. Currently, over $500 billion in MBS backed by Ginnie Mae is outstanding. Most mortgages backing Ginnie Mae MBS are FHA insured mortgages.

Most Ginnie Mae lenders are mortgage bankers, a group which includes independent firms without deposit bases as well as subsidiaries of depository institutions. This secondary market allows mortgage bankers to

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

compete in the primary market for loan originations even though they do not have a deposit base to finance the mortgages on their balance sheets. Due to competitive forces in the primary market and as a result of increased access to additional sources of funds for lenders, this secondary market has contributed to lower interest rates paid by borrowers on federally insured mortgages. Over 90 percent of single-family FHA mortgages have been sold in the Ginnie Mae MBS secondary market.

Over 70 percent of FHA insured mortgages are fixed-rate mortgages. These mortgages have greater interest rate risk than adjustable-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. Therefore, Ginnie Mae guaranteed MBS backed by FHA-insured adjustable-rate mortgages also entail interest rate risk for investors. As I discussed earlier, the presence of interest rate risk in a primary market increases the attractiveness of the secondary market to loan originators.

An investor in a Ginnie Mae MBS is to receive an offering statement that discloses the issuer of the MBS, which is normally the lender. Other information to be disclosed includes the value of loans in the pool and characteristics of the loans, such as whether they are 30-year fixed-rate or adjustable rate. The minimum pool size is eight loans, but most pools are much larger. For a fixed-rate MBS pool, interest rates paid by borrowers in the pool must be within one percentage point of each other. For MBS backed by adjustable-rate mortgage pools, the index used to adjust the interest rate paid by the borrower must be specified. Therefore, in estimating prepayment risk, the investor is helped by being able to analyze a relatively large and homogeneous loan pool issued by a particular lender. Investors in Ginnie Mae MBS include mutual funds, pension funds, insurance companies, and individuals.

Characteristics of the Guaranteed 7(a) Secondary Market Differ From Those of the Ginnie Mae MBS Market

In the guaranteed 7(a) secondary market, investors purchase certificates backed by cash flows from pools of the guaranteed portions of 7(a) loans. The secondary market for 7(a) pool certificates started in 1984. This market provides lenders a potential funding source to originate more small business loans. As I stated earlier, participating lenders include depository and nondepository financial institutions. Nondepository institutions benefit relatively more from this secondary market, because they do not have a deposit base to help them finance 7(a) loans on their balance

sheets. Particularly active among nondepository lenders are 12 SBLCs that accounted for about 19 percent of 7(a) loans outstanding at the end of 1997.

In this market, SBA 7(a) lenders sell their loans to pool assemblers who form pools by combining the loans of a number of lenders and then sell certificates backed by these pools. Colson Services, SBA's fiscal and transfer agent (FTA), monitors and handles the paperwork and data management system for all 7(a) guaranteed portions sold on the secondary market. Colson also serves as a central registry for all sales and resales of these portions. The firm receives payment from lenders for its secondary market services equal to 12 1/2 basis points of the value of certificates for guaranteed portions under Colson's management. In 1997, SBA 7(a) secondary market sales of pooled guaranteed portions was approximately $2.6 billion.

In contrast to Ginnie Mae guaranteed MBS that are backed by cash flows from whole loans, 7(a) loans are divided into separate guaranteed and unguaranteed portions for secondary market sales. SBA reported that in 1997 over 12,000 7(a) guaranteed portions were sold on the secondary market, about 40 percent of all 7(a) loans approved that year. In recent years, anywhere from a third to almost half of the guaranteed portions of loans originated have been sold on the secondary market. This is in contrast to Ginnie Mae guaranteed MBS, which represent over 90 percent of outstanding federally insured residential mortgage loans.

The guaranteed 7(a) secondary market is smaller and less active, and provides lenders with fewer incentives to sell loans than the federally insured residential mortgage market. At the end of 1997, about $10 billion in guaranteed portions of 7(a) loans were outstanding, while Ginnie Mae guaranteed MBS had over $500 billion outstanding. The 7(a) market does not benefit from the incentive for lenders to sell on the secondary market to mitigate interest rate risk, because the 7(a) program consists mainly of variable-rate loans without interest rate caps. Almost 90 percent of 7(a) loans made in 1997 were variable- rate loans without interest rate caps. Because interest rates are adjusted at least quarterly to reflect market rates, these loans entail almost no interest rate risk. In addition, SBA 7(a) loans can consist of loans backed by a variety of items, such as real estate, production inventory, or equipment, and 7(a) loans finance a broad range of businesses. Residential mortgages are all backed by residential property.

Because of the heterogeneous nature of 7(a) loans, analysts are less able to accurately estimate prepayment risks. Some participants in the secondary market for 7(a) guaranteed portions expressed concern that information useful to investors in analyzing prepayment risk is not available when pool certificates are resold, limiting investors' ability to resell in this market. SBA is concerned that providing such information to investors could reduce benefits to some 7(a) borrowers by potentially allowing investors to identify individual borrowers and groups of borrowers. According to SBA, all investors in 7(a) guaranteed pool certificates are institutional investors, such as pension funds, insurance companies, and mutual funds.

In summary, secondary market volume for both the guaranteed portions of 7(a) loans and federally insured residential mortgage loans is a market outcome that depends on the relative benefits provided by the respective secondary markets compared to other methods of finance.

For the most part, SBA has few if any means to change factors that, through market forces, limit the relative size of the secondary market. For example, heterogeneity in loan characteristics, which results from the 7(a) program's intention to serve a broad range of small businesses, limits the ability of investors to estimate prepayment risk.

As we continue our work, we will consider SBA actions that indicate the potential to improve the efficiency of the SBA 7(a) secondary market in achieving the objectives established for it.

Mr. Chairman, this concludes my prepared statement. I will be happy to respond to any questions you or other Members of the Subcommittee may have.

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