An Exploration of a Secondary Market for Small Business Loans

by

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I. Introduction and Summary

This report is motivated by small business credit market policymakers' concern that banks have not used the secondary market to raise capital for conventional small business lending.[1] Lenders now rely on deposits and corporate debt for capital; in the event that these two sources of liquidity decline, the lack of a secondary market for conventional small business loans may constrain the ability of lenders to meet the credit needs of small businesses. Yet, there are two recent trends—industry consolidation and credit scoring—that may have an impact on the feasibility of a larger secondary market for conventional small business loans. The purpose of this report is to examine the extent to which these trends, in fact, may make it easier for market participants to structure secondary market transactions that use conventional small business loans as collateral, and, in the future, provide an additional source of liquidity for conventional small business lending.

Changing Patterns in Small Business Lending

The Office of Advocacy at the U.S. Small Business Administration reports that, in 2001, 56 large banks had a total of $206 billion small business loans, about 45% of the total of $460 billion of small business loans outstanding. Moreover, these companies increased their share of small business loans between 2001 and 2002, despite an overall decline in the share of assets held by large banks.[2] According to 1998 data, banks with assets less than $10 billion accounted for about two-thirds of small business loans, but only one-third of total business loans.[3] This pattern may change as the banking industry consolidated in the 1990s, partly in response to regulators allowing banks to expand their scope across state boundaries. Between 1993 and 1997, 2,839 banking institutions were acquired through consolidations and acquisitions.[4] As a result, large banks now account for a growing share of small business lending: the small business loan

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[1] In this report, conventional small business loans are those that are not guaranteed by the Small Business Administration and any other Federal agency and state governments.

[2] Office of Advocacy, U.S. Small Business Administration. 2002. *Small Business Lending in the U.S., 2001 Edition*.

[3] Mester, Loretta. 1999. "Banking Industry Consolidation: What's A Small Business to Do?" *Federal Reserve Bank of Philadelphia Business Review*. January/February: 3-16.

[4] Avery, Robert B. and Katherine Samolyk. 2000. *Bank Consolidation and the Provision of Banking Services: The Case of Small Commercial Loans. FDIC Working Paper 00-01* http://www.fdic.gov/bank/analytical/working/01-1.pdf

portfolios of banks with more than $5 billion in assets increased from $158.2 billion in 1994 to $204.3 billion in 1999. Conversely, the overall value of loans controlled by small banks with assets less than $300 million fell from $95 billion to $92.3 billion over the same period.[5]

While larger banks have an increasing share of the conventional small business market, they are not originating the same kinds of loans as smaller banks. According to Mester, "large banks are using credit scoring to make small business loans and are processing applications using automated and centralized systems."[6] Such technologies, however, are mainly used to process small loans. Consequently, Mester points out that the increase in small business lending by large banks is almost completely accounted for by loans under $100,000, which can be assessed by underwriters who use data that is "easily verified, interpreted and quantifiable…"[7] Ely and Robinson, in a study of lending patterns between 1994 and 1999, found that smaller banks , which are less likely to use credit scores, increased their volume of loans over $100,000, during a period when small banks' overall lending declined.[8] As discussed later in this report, scoring models have been found to be predictive of small business loans less than $100,000. Therefore, such loans are easy for lenders to underwrite and originate. Larger banks, then, can take advantage of their economies of scale, and provide smaller loans more cost effectively than smaller banks.

The combination of industry consolidation and credit scoring is creating an increasing role for larger banks in the conventional small business lending industry. Will these changes affect the feasibility of a secondary market for conventional small business loans? As discussed later in this report, a number of studies have concluded that a major inhibitor to a secondary market for such loans is the lack of common underwriting in the small business loan industry. Indeed, many small business loans in the past have been originated by relatively small banks that use relationship underwriting to assess loan applications. Therefore, conventional small business loan portfolios are difficult to pool and use for asset backed securities (ABSs). For this reason, conventional small business loans (often referred to as Commercial and Industrial, or C&I loans) have not been securitized to the extent as other asset classes. Vandell notes that the $164 billion

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[5] Ely, David P. and Kenneth J. Robinson. 2001. "Consolidation, Technology and the Changing Structure of Banks' Small Business Lending." *Federal Reserve Bank of Dallas Economic and Financial Review* First Quarter: 23-32.
[6] Mester, 1999.:13.
[7] *Ibid*.
[8] Ely and Robinson, 2001: 27-28.

C&I loan market has "been relatively slow in its movement toward the secondary market."[9] Acs reports that only a fraction of the $370 billion in small business loans that were outstanding as of 1999 have been securitized: a striking contrast to other asset classes.[10]

In principle it is reasonable to assume that industry consolidation and credit scoring, to the extent that they increase underwriting standardization, will create the potential for a larger conventional small business loan secondary market. And, even without increased underwriting standardization, industry consolidation may enhance the feasibility of a secondary market because it creates larger pools of loans originated by single underwriters, thereby reducing transactions costs associated with pooling a given volume of loans. In order to assess these potential effects, we (1) reviewed previous studies on the potential for a secondary market for small business loans, small business lending, and the potential impact of credit scoring on small business lending; (2) interviewed secondary market participants who had direct experience with small business loan securitizations; and (3) based on this information, assessed the extent to which industry consolidation and credit scoring will affect the feasibility of a secondary market for conventional small business loans.

Summary of Findings

In summary, we find that large lenders are using credit scores to originate smaller loans, typically lines of credit (LOCs) for $100,000 or less. Large lenders continue to use relationship underwriting to assess loans over $100,000, mainly because the existing credit score models are not accurate for loans in excess of $100,000. These finding suggest that there is a potential for a secondary market for conventional small business LOCs, since these loans are underwritten with credit scoring models that are relatively standard across lenders. Larger loans, however, are less likely candidates to securitize, since even larger banks continue to use relationship underwriting. Therefore, industry consolidation will not result in common underwriting standards for loans over $100,000. However, secondary market participants said that this is not necessarily a barrier to an increased secondary market, since investment banks and rating agencies "underwrite underwriters." Therefore, as banks merge, there are larger pools of loans available for securitization from fewer originators, thereby reducing the number of companies that need to be

[9] Vandell, Kerry. 1997. "Improving Secondary Markets for Rural America." *Financing Rural America*. Federal Reserve Bank of Kansas City. 94.

underwritten to create a given pool of loans. Therefore, industry consolidation may improve the feasibility of a secondary market for conventional small business loans without reducing the level of underwriting standardization for larger conventional small business loans.

Report Structure

The remainder of this report analyzes the potential effect of industry consolidation and credit scoring on the feasibility of a larger secondary market for conventional small business loans, and is organized as follows. To provide context, we review in the next section how small business lending is conducted, including a discussion of the potential impact of credit scoring on the industry. Section 3 presents an analysis of how securitizations are structured, and reviews previous small business loan securitizations. In Section 4 we present the results of our discussions with depository lenders and other industry participants, and we conclude in Section 5, with a discussion of the findings and their policy implications.

[10] Acs, Zoltan. 1999. *The Development and Expansion of Secondary Markets for Small Business Loans.* Washington, D.C. RISE Business Research Institute for Small and Emerging Businesses.

II. The Mechanics of Small Business Lending

Unlike other types of credit markets, there has been little standardization in underwriting small business loans. In part, this is due to the nature of small businesses, which engage in a wide range of activities and have idiosyncratic credit needs. According to a 1998 Board of Governors of the Federal Reserve System report:

> "Historically, lenders have had difficulty determining the creditworthiness of small business loan applicants….Small businesses are extremely diverse - they range from small grocery stores to professional practices to small manufacturers. This heterogeneity, together, with widely varying uses of borrowed funds, has impeded the development of general standards for assessing small business loan applications and has made evaluating such loans less straightforward and relatively expensive."[11]

Different Types of Small Business Underwriting

The above characterization of small business lending is found across numerous studies.[12] Berger and Udell[13] provide a helpful typology for describing the multiple types of underwriting conventionally used by lenders in assessing small business loans. They distinguish among three types of transaction-based underwriting—financial statement, asset based, and credit-scoring—that are based on quantifiable information that is "relatively easily available at the time of loan origination"[14] and a fourth, relationship underwriting, based on personal knowledge of the firm, its owners, and their prospects. As Table 1 indicates, business loan underwriters can evaluate either a firm or its principal(s), or both. Therefore, depending on a company's size, an underwriter may place greater emphasis on the financial condition of a principal rather than on his or her company.

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[11] Board of Governors of the Federal Reserve System. 1998. *Report to the Congress of the Availability of Credit to Small Businesses.* Report: 29.
[12] See, for example, Beshouri, Christopher and Peter Nigro. 1994. *Securitization of Small Business Loans Office of the Comptroller of the Currency, Economic and Policy Analysis*, Working Paper, 94-8.
[13] Berger, Allen and Gregory Udell. 2001. "Small Business Credit Availability and Relationship Lending: The Importance of Bank Organizational Structure." *Monograph prepared for the Board of Governors of the Federal Reserve System.* April.
[14] *Ibid.*: 6

Table 1. Small Business Loan Underwriting Methods[15]		
Underwriting Method	Firm	Principal
Financial Statement	Underwriter makes decision based mostly on information provided in a firm's balance sheet and income statements. This type of underwriting is most appropriate for companies with certified audited financial statements; such firms tend to be large companies. Lenders may underwrite small firms using this method, but only such firms that have strong audited statements and a history with the lender.	Underwriter makes decision based mostly in information provided in a principal's personal balance sheet and tax returns. This type of underwriting is most appropriate for small businesses that do not have audited financial statements.
Asset-Based	Underwriter makes decision based primarily on the quality of the collateral offered by the borrower. Accounts receivables and inventory are the most frequently used types of collateral. This type of underwriting is available to all types of firms, but is expensive for lenders to assess the quality of the collateral.	Underwriter makes decision based primarily on the quality of the collateral offered by the principal. These assets may include a personal guarantee, or the principal's personal assets.
Credit Scoring	Underwriter makes decision based on the creditworthiness and financial condition of a firm's principal. Lenders typically restrict this type of underwriting to small loans: those below $250,000 (some lenders restrict this amount to $100,000).	Underwriter makes decision based on the creditworthiness and financial condition of a firm's principal. Lenders typically restrict this type of underwriting to small loans: those below $250,000 (some lenders restrict this amount to $100,000).
Relationship	Underwriter makes decision mostly based on proprietary information about a firm and its owner that is gained over time through a business relationship. This business relationship may include previous loans, deposits and other financial products. Moreover, the underwriter may use other types of more informal information collected through contacts with local suppliers and customers. "Importantly, the information gathered over time has significant value beyond the firm's financial statements collateral and credit score, helping the relationship lender deal with informational opacity problems better than potential transaction lenders."[16]	Underwriter makes decision mostly based on proprietary information about a firm and its owner that is gained over time through a business relationship. This business relationship may include previous loans, deposits and other financial products.

There is evidence in the literature that small business lending, due to its reliance on relationship underwriting, is more easily served by smaller banks. In an analysis of June Call Reports filed by banks, Peek and Rosengren found that small banks (categorized as having assets less than $100 million) increased their small business lending by 42% between 1993 and 1996; banks with assets over $3 billion increased their small business lending during this period by only 3%.[17] Similarly, Haynes, Ou and Berney, using data from the 1993 National Survey of Small Business Finances (NSSBF) found that larger firms are more likely to receive loans from larger commercial banks. Conversely, the authors report that smaller small businesses are less likely to utilize loan services from larger banks.[18] Some analysts believe that small lenders have an

[15] *Ibid.*
[16] *Ibid.*: 7.
[17] Peek, Joe and Eric Rosengren. 1998. "Bank Consolidation and Small Business Lending: It's Not Just Bank Size that Matters." *Journal of Banking Finance* 22(6-8): 799-819.
[18] Haynes, George, Charles Ou and Robert Berney. 1999. "Small Business Borrowing from Large and Small Banks." *Proceedings of the Federal Reserve Bank of Chicago* March: 287-327.

advantage in relationship lending, and so are better able to identify creditworthy small businesses. As Wilczynski posits:

> "[o]ne possible explanation for small banks' dominance of small business lending is the advantage small banks have with respect to information about potential borrowers. A community bank's relationship to the community and a particular borrower (especially persons who already are customers of the bank's other services) have likely been the source of a number of contacts between the bank and that borrower. Indeed, as a result of those contacts, small banks have traditionally had advantages over large banks in terms of information on local business and economic conditions and on borrowers who are already bank customers."[19]

The structure of small business lending - relationship lending that provides some advantages to small lenders - has an impact on the potential for a secondary market for such loans. Unlike other markets, a relatively small number of lenders do not have a disproportionate market share. Therefore, to achieve a relatively large securitization volume, secondary market participants would have to create pools of loans from a wide variety of underwriters. But, originators do not adhere to a common set of underwriting standards, thereby making it difficult to create a liquid secondary market. Previous studies of the potential for a secondary market have identified a lack of common underwriting standards as a key inhibitor. Feldman writes: "[t]he key to increased small business loan securitization is increasing standardization, which would bring down the costs of analyzing…loan pools."[20] In its report on the availability of credit to small businesses, the Federal Reserve Board says:

> "[s]ecuritization generally has thrived in markets for which the costs of acquiring and communicating information to investors and borrowers are low - as a result of standardized loan underwriting criteria and advanced in information technology, which have made estimating default probabilities and prepayment patterns easier under a variety of economic

[19] Wilczynski, Ann. 1999. "Credit Scoring, Securitization, and Small Business Loans: Are Changes in the Offing for Small Business Borrowers?" http://www.dted.state.mn.us/PDFs/CreditScoring.pdf.

> conditions..small business loans do not always fit easily within this paradigm…The loans are not homogeneous, underwriting standards vary across originators, and information on historical loss rates is typically limited."[21]

Relationship underwriting, then, has a direct impact on the ability of lenders to sell loans to the secondary market. Rather than use industry standards, lenders try to assess the credit needs of small business customers by becoming knowledgeable about their businesses, and in doing so gaining an understanding of the creditworthiness of a particular customer. To the extent that relationship underwriting is the predominant form of underwriting used by small business lenders, the secondary market for such loans will not be easily expanded. However, as discussed below, many lenders are using credit scores in underwriting small business loans. This trend may create a common set of underwriting standards, and so enhance the ability of lenders to sell their small business loans to the secondary market.

Credit Scoring and Small Business Lending

The benefits of credit scoring models to lenders are evident in their use in many types of consumer credit markets, including credit cards, auto loans, and since the mid-1990s, residential mortgages. Credit scores are based on the information provided by creditors to the three credit repositories: Equifax, Experian, and TransUnion. Based on this information, Fair, Issac and Company (FICO) developed a model that predicts the likelihood that a borrower will not remain current on a credit line. The model provides lenders with a score (often referred to as a FICO score) that ranges from about 400 to 800; borrowers who represent less risk receive higher scores. While the actual algorithm for the FICO score is proprietary, FICO's public information indicates that the most important factors affecting the calculation of one's score are previous payment behavior, current debt, the length of time one has used credit and pursuit of new credit.[22]

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[20] Feldman, Ron. 1995. "Will the Securitization Revolution Spread?" *The Region* September, http://www.minneapolisfed.org/pubs/region/95-09/reg959b.cfm: 7.
[21] Board of Governors of the Federal Reserve System. 1999. *Report to Congress on the Availability of Credit to Small Businesses*. Report.: 36-37.
[22] See the following link: http://www.myfico.com/myfico/CreditCentral/ScoringWorks.asp.

Credit scores, until relatively recently, have not been used by small business lenders. This, however, is changing: a 1997 survey of lenders reports that about 70 percent of respondents reported using credit scoring models when underwriting small business loans.[23] Larger lenders, with access to a large amount of internal data regarding small business loan performance, have developed in-house proprietary small business loan scoring models. In the past few years, Hibernia Corporation, Wells Fargo, Bank of America, NationsBank (before it merged with Bank of America), Fleet and Bank One had enough historical loan data to develop, test and use small business loan credit score models.[24] As a result, there is a positive correlation between a bank's size and its use of credit scoring models in small business lending production.[25] Vendors also provide commercial loan credit score models to lenders that do not have sufficient data to develop their own systems.[26]

In analyzing the performance of small business loans to develop scoring models, researchers found that the personal credit history of the owner was highly predictive of loan performance. It is important to note, however, that this relationship is strongest for smaller companies since these firms are likely to have the finances of the owner heavily commingled with the company.[27] Consequently, most lenders restrict their use of credit scoring models for small business loans less than $100,000.[28]

It is much more difficult for lenders and potential credit scoring model vendors to develop systems that can predict the performance of large commercial loans. Mester points out that such loans are less likely to be dependent on owners' personal credit history. Therefore, any model would require a wide variety of data relating to firms' financial conditions and loan performance. Moreover, any data would have to be pooled across lenders, since the annual default rate for business loans ranges between 1 and 3 percent.[29] As a result, most vendors

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[23] Ely and Robinson. 2001: 25.
[24] Mester, Loretta. 1997. "What's the Point of Credit Scoring?" *Federal Reserve Bank of Philadelphia Business Review*. September/October. :3-16.
[25] Ely and Robinson, 2001.
[26] Dun and Bradstreet and Experian currently offer small business loan scoring models, although Experian's model is predictive of the probability of bankruptcy for the principal, rather than for a firm. According to Dun and Bradstreet, its Credit Scoring Report has the following information for a given company: name, DUNS number, address, principal's name, SIC code and net worth. The model also produces a commercial credit score, which ranges from 101 (highest risk) to 660 (lowest risk); a credit score percentile and incidence of a delinquent payment (more than 90 days late) in the past 12 months.
[27] Mester. 1997: 5.
[28] Berger, Allen, W. Scott Frame and Nathan Miller. 2002. "Credit Scoring and the Availability, Price, and Risk of Small Business Credit." *Federal Reserve Bank of Atlanta Working Paper 2002-6*. April. http://www.frbatlanta.org/filelegacydocs/wp0206.pdf.
[29] Mester, 1997: 6.

recommend that their small business loan credit score models be used to assess applications for loans under $250,000. For example, Risk Management Association/Fair, Issac, and Company, which offers a small business loan credit score, says that its model is designed for a small business that has a credit exposure of less than $250,000.[30]

Our review of the literature reveals two important points regarding credit scoring and small business lending. First, an increasing number of lenders are using credit scoring models to evaluate small business loans. This augers well for the potential of a secondary market for such loans since the models provide for an objective and easily analyzed assessment of the risks associated with a given loan. However, lenders are not using credit scores to evaluate all of their small business loan applications. On the contrary, existing models are only useful for loans that are less than $100,000 and, in effect, are closely linked to the creditworthiness of a company's principal. As a result, the increased use of credit scores may increase the feasibility of a segment of small business lending—loans less than $100,000—to be securitized.

Summary

Small business lenders do not adhere to a standard set of underwriting guidelines. Indeed, most small business loans are evaluated by an underwriter who has a business relationship with the applicant. He or she used the information gained through this relationship to assess the overall soundness of the loan application, which is predicated on the firm's business model and management expertise. Some lenders use more objective underwriting models, similar to those used to evaluate residential mortgage applications. In most cases, however, such models are used to assess applications for relatively small loans (less than $100,000) and are heavily influenced by the credit history of a firm's principal.

Such models are less likely predictive of larger loans, which are typically originated to bigger firms. In these cases, the credit history of a firm's principal is less likely to be a major explanatory variable in determining an application's creditworthiness. Instead, it is more likely that payment performance of loans originated to larger firms is a function of a company's business practices: the type of information that is known by lenders which have a business relationship with the company.

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[30] Risk Management Association. Small Business Scoring Service. http://www.rmahq.org/Ed_Opps/SBSS/SmlBizScorSvc.html

Relationship underwriting has an effect on the feasibility of a secondary market for small business loans. In general, secondary markets develop for assets that have common elements, including relatively common underwriting standards, documentation information, servicing procedures and collateral. Small business lending, does not have common elements: it represents an extremely heterogeneous set of underwriting, documentation, servicing, and collateral across lenders. Therefore, the typical precondition for a secondary market - a homogenous asset class - is not available from the existing pool of small business loans now held in lenders' portfolios. Nonetheless, there have been some transactions executed with these loans, and they present a potential structure for future small business loans secondary market sales. We review them in the following section.

III. Conventional Small Business Loan Securitizations: History and Transaction Structures

The weakness of the secondary market for conventional small business loans has not gone unnoticed, and there have been some policy interventions to increase this market. The United States Congress in the early 1990s recognized the potential benefits to increasing the secondary market for such loans. The Congressional Research service, in a 1993 report found that: "[t]he development of a secondary market for small business loans - where loans would be pooled together, packaged as securities, and purchased and traded by investors - has the potential to improve the flow of capital to entrepreneurs, bringing economy-wide benefits in terms of increased output, innovation, and employment."[31] In recognition of the potential benefit of a conventional small business loan market, Congress passed the Riegle Community Development and Regulatory Improvement Act in 1994; its intent was to reduce regulatory barriers to the securitization of loans to small businesses and commercial real estate loans.

The Riegle Act was passed in recognition that asset securitization is an important source of liquidity in many financial markets. Lenders are no longer dependent on deposits for capital; indeed, non-depository institutions are important providers of credit in residential, commercial mortgage and consumer debt markets. There are thriving secondary markets for asset backed security markets for credit card receivables, student loans, automobile loans, equipment leases, etc.[32] Such markets complement the more established secondary market for residential mortgages, which has been active since the early 1980s.[33]

To facilitate a larger conventional small business loan secondary market, the Riegle Act extended the benefits of the 1984 Secondary Mortgage Market Enhancement Act (SMMEA), which had previously applied to residential mortgage securitizations, to small business and commercial real estate loan ABS. SMMEA benefits include the elimination of state-level

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[31] Jicking, Mark. *Secondary Market for Small Business Loans* Washington, D.C.: Congressional Research Service. Report.: 1.
[32] Bushaw, Amy. 1998. "Small Business Loans: Testing the Waters." *The Journal of Small & Emerging Business Law* Vol 2(1): 197-257.

investment restrictions and securities registration requirements. By extending these benefits to small business loan ABSs, the Riegle Act reduced the costs associated with issuing such securities.[34]

The Riegle Act also instructed federal bank regulators to change their risk-based capital requirements for depository institutions that securitize their loans but retain the risks associated with the sold loans through either a recourse agreement or retaining the residual tranche of a multi-class issuance. With respect to capital requirements for sales with recourse, or with a retained residual tranche, a depository lender may not be required to hold risk-based capital that exceeds the amount of contractual liability under the sale. Prior to passing the Riegle Act, lenders may have been required to hold risk-based capital that exceeded the potential liability; this requirement provided an obvious disincentive for depository lenders to securitize small business loans.[35]

Conventional Small Business Loan Secondary Market Transactions

Yet, despite the Riegle Act, there have been relatively few conventional small business loan securitization transactions. According to a 2000 Federal Reserve report, there were only 59 transactions between 1994 and 2000 that used either unguaranteed portions of SBA 7(a) loans or conventional small business loans as collateral, and these transactions included only $6.4 billion of loans.[36] The Money Store, a non depository lender that later merged with First Union (and then was subsequently closed by that bank) issued about 30 percent of the overall volume of such securities between 1993 and 1999. AMRESCO was the second largest issuer, as measured by volume; it accounted for 19 percent of the issuances over that same time period.[37] The securitization volumes for the market as a whole, and for The Money Store and AMRESCO are small, especially considering that a total of $1.2 trillion worth of Commercial and Industrial loans

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[33] Ranieri, Lewis. 1998. "The Origins of Securitization, Sources of Its Growth, Its Future and Potential." in Leon T. Kendall and Michael J. Fishman (eds.) *A Primer on Securitization* Cambridge, MA.: The MIT Press.

[34] Board of Governors of the Federal Reserve System. 1996. *Report to Congress on Markets for Small-Business and Commercial-Mortgage-Related Securities*. Washington, D.C. Report.

[35] *Ibid.*

[36] Board of Governors of the Federal Reserve System. 2000. *Report to Congress on Markets for Small-Business and Commercial-Mortgage-Related Securities*. Washington, D.C. Report.

[37] *Ibid.*

were originated between 1994 and 2000.[38] While the secondary market for conventional small business loans is quite small, there is a strong secondary market for loans guaranteed by the Small Business Administration 7(a) program. Between 1995 and 2000, an average of 43% of such loans were securitized each year, with about 52% of the guaranteed portion of 7(a) loans securitized in 2000.[39] The reason for this relatively strong market is clear: the guaranteed portions of SBA 7(a) loans do not have the risks associated with conventional small business loans. Since the federal government guarantees payment in the event of a default, investors do not have to be concerned with the underwriting standards used by the originators.[40]

There is also a developing secondary market for the unguaranteed portion of SBA 7(a) loans. Between 1995 and 2000, an average of 8.5% of the total unguaranteed volume of SBA 7(a) loans were securitized.[41] Although the assets used in these securitizations do not contain a federal guarantee, the loans are underwritten and documented in a relatively homogeneous manner, thereby increasing the comfort level of potential investors and other market participants.[42]

Typical Conventional Small Business Loan ABS Transaction Structure

Any increase in secondary market activity for conventional small business loans is likely to occur from a more liquid market for securities that are developed with such loans as collateral. In such a transaction, the underlying cash flow generated from the mortgages used as collateral is structured in order to create certificates that differ by expected maturity and risk grade. This structure mitigates some of the credit risks associated with the underlying mortgages to certain investors, while allowing those investors with a higher risk tolerance potentially to earn above-market returns.

Certificates or bonds that represent the lowest credit risk to investors are included in the senior tranche, while other certificates that are more risky are issued as part of subordinate

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[38] *Ibid.*

[39] *Ibid.*

[40] Bushaw. 1998.

[41] Board of Governors of the Federal Reserve System. 2000.

[42] Bushaw. 1998.

tranches.[43] The proceeds generated from the underlying mortgages are applied sequentially to each tranche: the senior certificate holders are paid first until all payments owed those investors are met. After the senior tranche is paid in full, the remaining funds are used to pay the investors in the subordinate tranches. Any payments left over after these tranches have been paid in full are received by the holders of the residual or unrated tranche. As a result, the residual tranche's payment to the investors is most likely to be affected by defaults, while the senior tranche is the most insulated from credit risk.[44]

Almost all ABSs have some form of credit enhancement, which provides investors with confidence that they will receive payment, even if the underlying assets fail to perform. There are two types of credit enhancement available for such securities: external and internal. External credit enhancements are provided by third parties who offer financial guaranty insurance issued by monoline insurers. Internal credit enhancement is different: the underlying assets themselves provide the cushion in the event of late payments.[45] There are three common internal credit enhancements: senior-subordinate structure, overcollateralization and excess spread accounts.

In a senior-subordinate structure, the issuance includes senior and subordinated debt. The cash proceeds are first paid to the senior debt holders, then the subordinate debt holders. In a sense, the subordinate debt acts as a loan loss reserve for the senior debt, thereby allowing the senior debt to receive an investment grade rating. The relative size of the subordinate debt will vary depending on the risk and expected losses associated with the underlying assets. To receive an investment grade, other things help equal, subordinate debt will account for a larger share of the overall issuance where the underlying assets demonstrate a higher level of risk.

In an overcollateralization transaction, the total unpaid principal balance of the assets used as underlying collateral is greater than the ABS issued. As an example, assume that there is a loan portfolio with $10 million in unpaid principal balance. The quality of these assets may be such that they can provide collateral for investment grade ABS worth $9 million. As a result, the

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[43] Tranches within a CMO (now called Real Estate Mortgage Investment Conduits (REMICs) represent separate financial instruments that are created from the underlying cash flow provided by the mortgages used as collateral. Tranches are designed to provide investment opportunities that differ by credit risk, yield, and maturity date.

[44] DeLiban, Nancy and Brian P. Lancaster. 1995. "Understanding Nonagency Mortgage Security Debt." *Journal of Housing Research*. Vol 6(2): 197-216.

[45] Kohler, Kenneth E. 1998. "Collateralized Loan Obligations: A Powerful New Portfolio Management Tool for Banks." *The Securitization Conduit* Vol. 1(2): 5-19.

issuance is overcollateralized: there are $10 million in assets supporting $9 million worth of bonds. In effect, the excess collateral acts as a loan loss reserve, and so provides a credit enhancement to investors.

The third type of credit enhancement, excess spread accounts, is derived from the difference between the interest rate of the underlying mortgage pool and the interest rate paid to investors. For example, the weighted average interest rate for a pool of mortgages may be 9 percent, while the average interest rate of the ABS issued to investors is 8 percent. The difference between the payments received from the loans originated to borrowers and paid to investors can be used as a loan loss reserve, thereby providing a credit enhancement to investors.

Many transactions use a combination of internal credit enhancements. Therefore, it is possible for an ABS to have a senior-subordinate structure, combined with overcollateralization and an excess spread account. Of course, the issuer may decide to use an external credit enhancement as well in order to provide even more assurance to investors. The transaction's structure, ultimately, is a function of the relative costs associated with different types of credit enhancements, the quality of the underlying collateral and investors' trade-offs of risk and return. In general, the amount of credit enhancement required for a particular transaction is directly related to the risk and volatility of the underlying collateral. Therefore, an ABS that uses prime conforming mortgages as collateral will require less credit enhancement to receive a given price than an ABS that uses mortgages that do not meet conforming underwriting criteria. Investors in such ABS will demand a higher level of assurance that they will be paid in the event of loan delinquencies and defaults, or will offer a lower price for the ABS to offset the higher level of risk.

Figure 1 shows a schematic diagram of a typical conventional small business loan securitization. As indicated in the left-hand side of the figure, which shows how most small business loans are originated, small business lenders typically require a borrower to place between 25 and 30% equity in the transaction.[46] This serves two purposes: (1) the borrower's equity contribution makes it less likely that he or she will default on the loan, and (2) the lender is more likely to recover the unpaid principal balance of the loan in the event of a default. In effect,

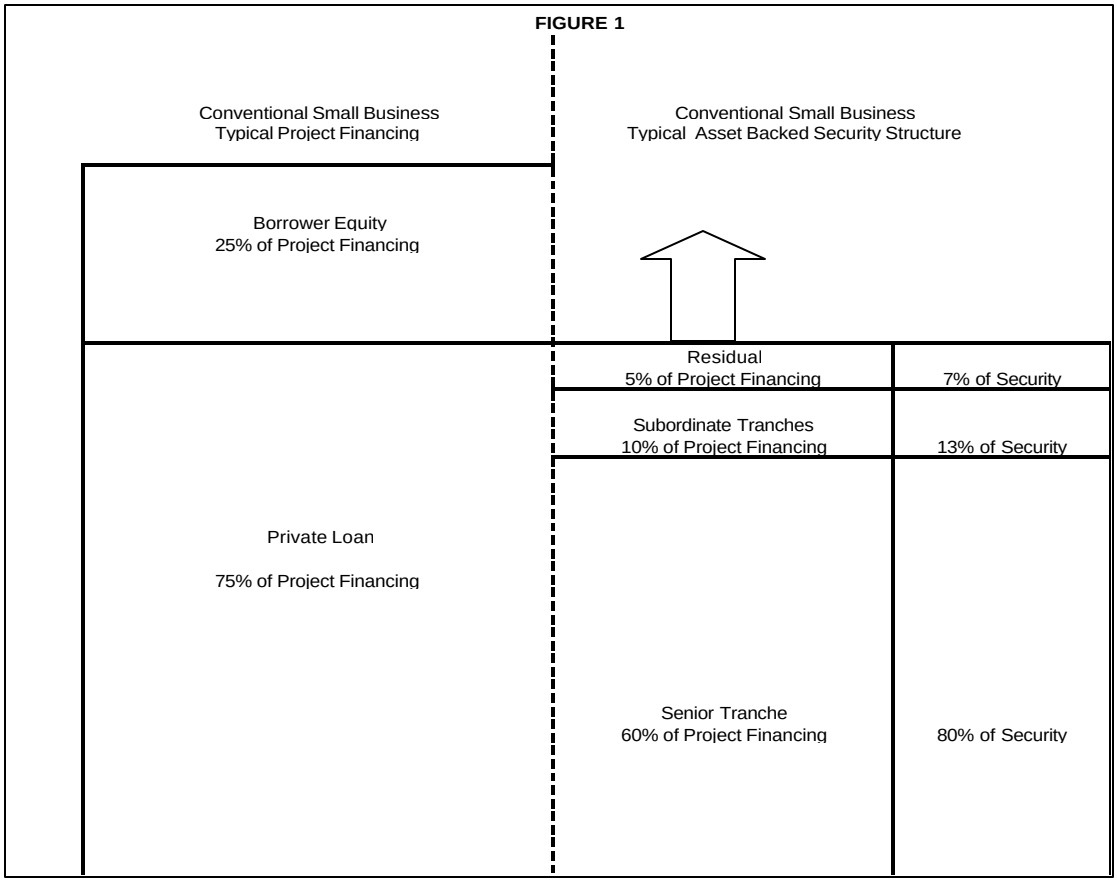
[46] Federal Reserve System. 1998. *The Significance of Recent Changes in Bank Lending Standards: Evidence from Loan Quality Assessment Project.* Washington, D.C. Report. http://www.federalreserve.gov/boarddocs/SRLetters/1998/sr9818a2.pdf.

the borrower assumes the first loss position, and therefore provides security to the lender beyond that in the underlying value of the assets used as collateral.

The right-hand side of the figure shows how conventional small business loans are securitized. The senior tranche accounts for 80% of the total securitization and is "below" subordinate tranches and a residual. This means that the subordinate debt and residual portions of the securitization absorb losses that result from delinquencies and defaults of the underlying loans used as collateral. Overall, the relatively risk-free senior tranche represents (80% of the 75% private loan) 60% of total projects financed with conventional small business loans.

Most of the conventional small business loan and unguaranteed SBA 7(a) securitization transactions have been structured in a manner that is similar Figure 1. As indicated in Table 2, the overwhelming majority of small business loan transactions used the unguaranteed portions of SBA 7(a) loans as collateral. In fact, only the Fremont Financial Series A and B transactions in

FIGURE 1



1993, 1995, 1996 and 1997 and the Concord Finance transaction in 1996 used non real-estate small business loans. This pattern underscores the relatively thin secondary market activity that exists for conventional small business loans.

While relatively few in number, there is a common structure among the transactions. All but one transaction (Zions First in 1994) used a senior subordinate-structure to provide a credit enhancement to the senior debt. In addition, many of the transactions had a spread account, which utilizes the difference between the weighted average coupon of the underlying loans and the interest rate demanded by investors for similarly rated securities. In most cases the spread account provided a further level of protection to the transaction, beyond that of the subordinate debt. The level of subordination was usually less than 10% of the total transaction; typically it was between 4% and 9%. This means that the loan performance and expected losses for the loans in the pools used as collateral, combined, was expected to be no greater than 3-4%. This is not too surprising, since so many of the transactions used the unguaranteed portion of SBA 7(a) loans.

The credit enhancements required to make conventional small business loan ABSs attractive to investors have a negative effect on the execution of the companies that sell their loans. The relatively small number of conventional small business loan secondary market transactions creates a viscous circle: the lack of transactions means that there is a lack of information regarding the performance of such loans; the lack of information makes investors more conservative in pricing securities that use economic development loans as collateral, therefore, potential sellers of loans believe that investors' uncertainty will result in an unfair price for their loans, thereby reducing the secondary market supply of loans.

Table 2. Rated Small Business Loan Transactions 1992-1998

				Credit Enhancement			
Issuer	Issue Date	Amount ($ million)	Collateral Type	Amount (percent)	Type	Class	Credit Rating
Chrysler First Business Credit (1992-1)	01-92	522.7	Small business loans secured by real estate	35	Subordination		
		288.2				A-1	AAA
		61.5				A-2	AAA
		72.0				B	n.r
		101.0				R	n.r
The Money Store (1992-1)	n.a.	51.3	Unguaranteed portions of SBA 7(a) loans	9 4	Subordination Spread Account		
		47.1				A	AAA
		4.2				B	A
The Money Store (1993-1)	04-93	76.3	Unguaranteed portions of SBA 7(a) loans secured by owner-occupied commercial real estate	9 4	Subordination Spread Account		
		69.4				A	AAA
		6.9				B	A
Fremont Financial (Series A)	04-93	200.0	Revolving Credit Advances	19	Subordination	A	AAA
Fremont Financial (Series B)	11-93	100.00	Revolving Credit Advances	19	Subordination	A	AAA
The Money Store (1994-1)	09-94	129.9	Unguaranteed portions of SBA 7(a) loans secured by owner-occupied commercial real estate	9 4	Subordination Spread Account		
		118.2				A	AAA
		11.7				B	A
Zions First	11-94	45.0	Unguaranteed portions of SBA 504 loans secured by commercial real estate	n.a.	Bond Insurance	A	n.r.
PMC Capital	12-94	27.0	Unguaranteed portions of SBA 7(a) loans secured by real estate	6 5	Subordination Spread Account		
		24.8				A	Aaa
		1.6				B	n.r
		0.6				C	n.r
Fremont Financial	04-95	30.0	Revolving credit advances	11	Subordination	A	BBB
The Money Store (1995-1)	06-95	124.9	Unguaranteed portions of SBA 7(a) loans	7 4	Subordination Spread Account		
		116.2				A	AAA

Table 2. Rated Small Business Loan Transactions 1992-1998

				Credit Enhancement			
Issuer	Issue Date	Amount ($ million)	Collateral Type	Amount (percent)	Type	Class	Credit Rating
		8.7				B	A
Emergent Business Capital	07-95	17.0	Unguaranteed portions of SBA 7(a) loans	2	Spread Account	A	Aaa
Fremont Financial (Series C)	02-96	135.0	Revolving credit advances (secured)	19	Subordination	A	AAA
The Money Store (1996-1)	03-96	100.0	Unguaranteed portions of SBA loans	7.0 3.5	Subordination Spread Account		
		93.0				A	AAA
		7.0				B	A
Concord Finance (1996-A)	03-96	20.0	Small business loans	n.a.	Subordination		
		18.0				A-1	AA
		1.0				A-2	BBB
		1.0				A-3	BB
Carolina First SBL Trust 1 (1996-C1)	03-96	117.5	Small business loans secured by real estate	16 5	Subordination Reserve Account		
		40.1				A-1	Aa2
		41.0				A-2	Aa2
		17.6				B	Baa2
		18.8				C	n.r.
Emergent Business Capital (1996-1)	11-96	17.5	Unguaranteed portions of SBA loans	9.0 6.0	Subordination Spread Account		
		15.9				A	Aa
		1.6				B	n.r.
The Money Store	12-96	140.0	Unguaranteed portions of SBA loans	7.0 3.5	Subordination Spread Account		
		130.2				A	Aaa
		9.8				B	n.r
The Money Store	03-97	90.0	First mortgages secured by commercial real estate associated with 504 and 7(a) loans	8.0 3.5	Subordination Spread Account		
		75.6				A	AAA
		7.2				M	AA
		7.2				B	BBB
Fremont Financial	04-97	109.3 100.0	Small business loans	9.0	Subordination		
		9.3				A	AAA
						B	BBB

Table 2. Rated Small Business Loan Transactions 1992-1998

				Credit Enhancement			
Issuer	Issue Date	Amount ($ million)	Collateral Type	Amount (percent)	Type	Class	Credit Rating
Sierra West (1997-1)	06-97	51.3	Unguaranteed portions of	7.0	Subordination		
			SBA loans	4.0	Spread Account		
		47.7				A	Aaa
		3.6				B	A
The Money Store	09-97	140.0	Unguaranteed portions of	7.0	Subordination		
			SBA loans	3.5	Spread Account		
		130.2				A	AAA
		9.8				B	A
Independence Funding (1997-1)	11-97	34.3	Unguaranteed portions of	10.0	Subordination		
			SBA loans	4.0	Spread Account		
		30.9				A	Aaa
		3.4				B	A
First Western (1997-1)	12-97	22.6	Unguaranteed portions of	7.0	Subordination		
			SBA loans	6.0	Spread Account		
		21.2				A	Aaa
		1.6				B	n.r.
Business Loan Center (1997-1)	12-97	19.9	Unguaranteed portions of	9.0	Subordination		
			SBA loans	4.0	Spread Account		
		16.1				A	Aaa
		1.6				B	n.r.
Emergent Business Capital (1997-1)	12-97	21.5	Unguaranteed portions of	10.0	Subordination		
			SBA loans	6.0	Spread Account		
		19.4				A	A
		2.2				B	n.r.
The Money Store (1998-1)	03-98	90.0	Unguaranteed portions of	7.0	Subordination		
			SBA loans	3.5	Spread Account		
		83.7				A	Aaa
		6.3				B	A
Heller First Capital (1998-1)	06-98	96.0	Unguaranteed portions of	4.0	Subordination		
			SBA loans	2.0	Spread Account		
		75.9				A	Aaa
		6.7				M-1	AA
		3.8				M-2	A
		5.8				M-3	BBB
		3.8				B	BB
First National Bank of New England (1998-1)	06-98	26.9	Unguaranteed portions of	10.0	Subordination		
			SBA loans	7.0	Spread Account		

Sources: Board of Governors of the Federal Reserve System. 1996, 1998, 2000.

Given this circle, there is a clear interaction between the potential supply and demand in a secondary market for conventional small business loans. With perfect information, investors would be able to estimate, with a high degree of certainty, the expected probability of loans going into default, and the recoveries from any foreclosures. These expected losses would add a premium to a security over risk-free bonds with a similar maturity. As an example, assume that the interest rate for a 7 year Treasury bill is 4.5%, and that the weighted average interest rate for a pool of conventional small business loans 9.0%. For the loan sellers to receive full price for the pool, investors would have to judge that the expected losses from the pool would be fully offset by the higher interest rate. However, in order to make an accurate pricing determination, investors would need to know, with some precision, what the expected losses will be over time. In the absence of such information, investors are likely to demand a return over the objective risk premium. This dynamic makes it difficult for participants to arrive at a market clearing price: sellers do not want their loans sold at too steep a discount while investors will only enter the market if they receive returns that adequately compensate them for the risk and uncertainty inherent in a market with little information.

In principle, bank consolidations that result in larger pools of loans and credit scoring can reduce the uncertainties inherent in structuring transactions that use conventional small business loans as collateral. This would mean that the credit enhancements required by investors would decline, and approach a level that accounts for the expected losses of the loan pool. Over time, then, a secondary market could provide another source of capital and augment deposits and corporate debt markets for liquidity. We discussed this possibility with representatives of large depository lenders; the results of our discussions are summarized in the following section.

IV. Discussions with Depository Lenders Regarding the Feasibility of a Secondary Market for Conventional Small Business Loans

We conducted discussions with industry participants—large depository lenders, non-depository lenders, investment bankers and rating agency representatives—in order to assess the extent to which a larger secondary market is feasible. These discussions were semi-structured, and followed discussion guides developed in advance. We contacted representatives of 20 companies that participate in the conventional small business loan industry, and conducted interviews with representatives of eight companies. While the results of these discussions are not scientifically representative of all industry participants, they do provide insights from knowledgeable market observers who participate in small business lending.

Relationship Underwriting is Still Prevalent for Large Loans and is Likely to Continue

The information provided by the depository lenders' representatives and other market participants corroborated many of our findings derived from the literature review. First, large lenders, despite originating loans across a broad geographic region, continue to conduct relationship underwriting for loans over $50,000. According to a depository lender's representative, larger loans are structured and priced by a "relationship officer" who has the responsibility of maintaining a full business relationship with a given customer. Therefore, individual loans to a particular customer reflect an overall business need, rather than the credit quality of the specific collateral offered for the loan. For this company, the representative said, small business lending "is more of an art than a science." As a result, loans in excess of $50,000 are not credit scored. Another depository lender's representative said that the industry has not developed a generally accepted asset quality model, and so the firm does not use credit scores for loans over $100,000.

A non-depository lender's representative said that her company did use an automated underwriting system, but that the system was specific to each customer. The in-house model analyzes three years of credit history, historical and current debt and debt to service ratios to determine a company-level measure of stress. As a result, this lender only originated loans to companies that were in business for at least three years. The lender relies on its field representative to underwrite loans, although the company has a centralized processing and servicing center that supports the field representatives. Another non-depository lender's

representative said that his company did not use credit scores or automated underwriting; rather, the firm used Business Development Officers (BDOs) who have the responsibility to develop relationships with brokers and accountants who can refer clients to the company. BDOs have the authority to per-qualify applicants, but a centralized loan committee reviews all applications in excess of $1 million.

The key point here is that large lenders, both depository and non-depository companies, continue to rely on relationship underwriting for larger loans. Nobody interviewed for this report believed that this pattern would change, even with industry consolidation. The reason is that small business lending, even for large banks that cover many states, remains a relationship-based industry. Larger companies can centralize back-office functions, such as processing loan applications and servicing, but underwriting large loans continues to be an art that has not yet been successfully modeled. Consequently, underwriting heterogeneity is likely to remain as a key barrier for securitization of larger small business loans, even as the banking industry continues to consolidate.

Credit Scores are Used for Small Lines of Credit

The depository lender representatives we spoke with said that their firms offer small business lines of credit of up to $50,000. Applications for such loans, they said, are assessed with the use of credit scores that are based on in-house systems. These systems derive credit scores for LOC applicants primarily from the credit score of the company's principal. None of the interviewees said that current credit scoring models are predictive for loan over $250,000, and many believed that such models are accurate for loans over $100,000. As a result, bank representatives we spoke with are limiting their use of credit scores to relatively small loans.

Some interviewees said that small business LOCs, since they are underwritten with credit scores, are amenable to securitization. Therefore, they said that any increase in a secondary market for conventional small business loans is likely to start with these loans, since there is relatively good data regarding their performance over time. Therefore, according to the interviewees, it would be relatively easy for conduits to create transaction structures that meet credit rating agency requirements for credit enhancements. Indeed, these LOCs appear to be similar in structure to consumer credit cards, which are securitized in a highly liquid secondary market.

Is a Larger Secondary Market for Conventional Small Business Loans Feasible?

Relevant and reliable data are necessary for a secondary market because they provide market participants with an objective basis for making decisions. Investors, rating agencies and sellers can assess fair prices for loans when they have historical information relating to asset performance through different economic environments, loss rates in the event of defaults and prepayment probabilities. In contrast to the residential and commercial mortgage market, there are much less data available on the performance of conventional small business loans. Lack of data was an issue raised by nearly all of the industry participants we spoke with, including representatives of rating agencies, lenders and investment banks regarding the feasibility of a secondary market for these loans. According to one key informant, the biggest problem in increasing the secondary market volume for conventional small business loans is that historical loan performance and loss rate data are not available.

Because so little information is available to potential market participants, rating agencies and investment banks assess the potential payment performance of conventional small business loan pools by comparing the characteristics of a proposed loan pool to be securitized those that have already been securitized and have had loan performance tracked. A rating agency said that his company, in effect, assumes that a given originator's loan pools will exhibit consistent performance, so long as the underlying loans are the same. Therefore, the rating agency *"underwrites the underwriter,"* by spending time learning the originators loan production process, which includes marketing, underwriting and servicing. This type of analysis, however, is time consuming, since it requires a rating agency to spend a considerable amount of time with a potential loan seller. Therefore, it may be relatively costly for a lender to have its first loans sale rated, since a rating agency would not only have to conduct due diligence analysis of the loan pool, but also of the lender. However, industry consolidation creates an opportunity, as rating agencies and investment banks can underwrite fewer underwriters to create a pool of loans with a given unpaid principal balance.

Each of the lenders said that they would want to retain the servicing for any loans sold to the secondary market. However, they would not know, at present, what would be an acceptable servicing fee to charge. Each loan's servicing costs reflect the relationship the company has with a given customer. Therefore, it would be difficult to derive a standard servicing fee, which is calculated for conventional home mortgages sold to Fannie Mae and Freddie Mac. Moreover,

lenders interviewed for this study did not view a larger secondary market for conventional small business loans as a requirement for liquidity. Moreover, the relatively short term and high interest rates obviated the need for lenders to sell the assets. Therefore, the depository lender representatives we spoke with were very lukewarm about the need for a more active secondary market for such loans.

It is for these reasons that there has been relatively little secondary market transactions for conventional small business loans. Although many of these challenges are not ameliorated by industry consolidation or credit scoring, these two trends may result in a larger secondary market for conventional small business loans. While industry consolidation may not necessarily lead to increased underwriting standardization for conventional small business loans over $250,000, since these loans continue to be originated through relationship underwriting, there are increasingly larger portfolios of such loans held by larger lenders. This trend, then, reduces the costs associated with underwriting underwriters, and so may improve the execution of transactions. Small business LOCs, which are underwritten with credit scores, are reasonably good candidates for securitization.

Will there be a larger secondary market for conventional small business loans? Industry consolidation and credit scoring do enhance the potential for a secondary market, but lenders may not want to sell such loans, since they are originated with interest rates that more than adequately compensate them for the risks associated with the loans. Moreover, lenders will likely want to retain the servicing rights to the LOCs, thereby requiring lenders to calculate appropriate servicing fees and other arrangements that make it easier for the originators to maintain a business relationship with their customers, even after selling loans. Therefore, the secondary market for conventional small business loans is likely to remain sluggish, but industry consolidation and credit scoring will favorably affect the execution of such transactions if and when they are conducted.

V. Summary and Policy Implications

The issues raised by market participants all revolve around a central theme: the relatively small existing secondary market for conventional small business loans results from an overarching sense of uncertainty. This uncertainty is exacerbated by the lack of standard lending and servicing practices followed by loan originators, which may be reduced by industry consolidation. The only way to reduce uncertainty, many informants said, is to make more information available to potential market participants. Some informants said that the SBA could help to facilitate such a process, by making its historical loan performance and loss data available to the public in an accessible form.

Other informants, however, did not believe that a relatively small secondary market for conventional small business loans represented a problem that required a government intervention. Indeed, most informants believed that there was no lack of liquidity for conventional small business lending; depository lenders have access, through deposits and corporate debt markets to enough capital to satisfy the demand for conventional small business loans. In addition, some small business lenders have been purchased by larger, more well-capitalized companies that do not need to access the secondary market. For example, First International Bank was purchased by UPS. After the sale, First International had no need to raise capital on the secondary market. Given these trends, most informants did not think there was a compelling reason for the government to take proactive steps and increase the size of the secondary market for conventional small business loans.

> Whether or not informants believed a small conventional business loan secondary market was a problem, all agreed that it would not grow without lenders using common underwriting and documentation standards. Indeed, a lack of uniformity of underwriting was cited as the most important impediment to a secondary market. This sentiment is corroborated by other studies.

An increase in the use of credit scoring by small business lenders increases the level of standardization across originators, which does make it easier for securitizers to pool loans from different originators. This is certainly true for loans under $100,000, which are often

underwritten with credit scores. The lack of standard underwriting for loans over $100,000, even among larger lenders, does not make it impossible to securitize small business loans. Secondary market participants, including rating agencies and investment banks, typically underwrite a particular company's loan production process. Therefore, these market intermediaries now have access to larger pools of loans that are originated by a single company. This reduces the costs associated with underwriting a given transaction, since it is easier to structure a transaction of a given size with only one company's loans.

Some interviewees said that the SBA, or other government agency, by providing less expensive credit enhancements, could increase the number of feasible conventional small business loan securitization transactions. This suggestion is consistent with Bushaw's analysis, in which she suggests that a government sponsored enterprise (GSE) could assist in securitizing small business loan pools, and in doing so, help provide information to potential private market participants.[47] Bushaw points out that this type of intervention is not without precedent. The federal government, through the RTC, helped to establish the commercial mortgage backed security (CMBS) market. Indeed, Vandell points out that the securities developed and sold by the RTC "showed the way" for private CMBS market participants.[48] In effect, the CMBS market was "jump-started" by the federal government's large RTC portfolio that had to be sold in the secondary market. These transactions demonstrated the possibility of such a market, and CMBS volumes increased from $7 billion in 1991 to over $62 billion in 2002.[49]

While government intervention may facilitate a larger secondary market for conventional small business loans, such a program would likely lead to increased standardization in underwriting and documentation. Some informants said that any benefits from increase in liquidity resulting from a larger secondary market could potentially be offset by more rigid underwriting. Therefore, some lenders may be unwilling to implement underwriting standards that are dependent more on the expectations of secondary market participants than on the needs of small business customers. Small business lenders which rely on relationship lending are likely to be hesitant to adopt industry-wide standards that preclude them from serving their customers.

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[47] Bushaw, 1998.

[48] Vandell, 1999.

[49] Moody's Investors Service. *U.S. CMBS Volume to Slow in 2002 as Delinquencies Rise, International CMBS Issuances Set to Grow* http://www.rebuz.com/research02/0102/moodys_CMBS_2002_outlook.htm

Overall, most of the key informants we interviewed for this study said that there are few compelling reasons for a larger secondary market for conventional small business loans. There is not a liquidity crunch, and small companies have not had trouble in meeting their credit needs. The factors present in other, more mature secondary markets - homogeneous asset pools, standardized underwriting, easily accessible loan performance and loss data - are missing in the small business lending market. Therefore, predictions made by analysts in the mid- to late-1990s regarding a larger secondary market for small business loans have not materialized. Indeed, Acs, in his study of the inhibitors of a secondary market for small business loans, concluded that: "…securitization of small business loans does not appear to appeal to either large- or small-banks…Current market conditions - where everyone is everyone is flush and liquidity is less of an issue - create less demand for securitizations."[50]

Of course, economic conditions can change, and the liquidity for small business lending may become a problem in the future. Small business loan originators, at some point may want to have access to a secondary market for their loans. Our analysis suggests that industry consolidation and credit scoring will make it easier to structure such transactions, and provide for better execution.

[50] Acs, 1999.: 635-636.

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