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Testimony by

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I am here today to discuss the Small Business Loan Securitization and Secondary Market Enhancement Act (S.384), which seeks to increase the availability of credit to small businesses by facilitating the securitization of small business loans. The objective of this bill is extremely important, particularly given the problems that small businesses have had in obtaining adequate credit accommodation. Moreover, experience in other sectors of the credit markets where securitization has taken place suggests that securitization of small business loans could accrue similar benefits to banks and other financial institutions that originate and securitize these loans.

Accordingly, the Federal Reserve supports the objectives of S.384. While we have not seen a final version of the bill, we believe, based on discussions with staff of this Committee, that many of its provisions will prove helpful in encouraging the development, through the securitization process, of a secondary market for small business loans. We also support the bill's approach of promoting this development by relying on the private sector rather than involving the government through yet another guarantee program.

Successful small businesses are vital to the well-being of the U.S. economy. Indeed, the use of the word small to describe this sector of the business community is, in a sense, misleading. In the aggregate, the volume of business activity generated by small- and medium-sized firms accounts for

approximately one-half of the employment and receipts in the nonfinancial, nonfarm business sector.

Small- and medium-sized businesses have become increasingly important to the American economy over the past two decades. Recent gains in employment have occurred largely in those industries that are dominated by such businesses, specifically retail trade and services. Given this experience, we believe that the prospect for future growth and prosperity depends importantly upon the vitality and performance of small- and medium-sized businesses.

A key element in the success of smaller firms is their ability to obtain adequate credit accommodation. Traditionally, the commercial banking system has been the principal source of credit to smaller businesses, and the small business segment has contributed importantly to the earnings of banks.

Unfortunately, in recent years, many banks have had to deal with substantial loan quality problems and have experienced significant losses. Consequently, after nearly a decade of aggressive lending--often on terms much more liberal than warranted by the credit standing of their borrowers--banks have been working to improve their balance sheets and many have tightened their lending standards. While this is clearly a necessary development, one adverse effect is that the ready

availability of credit to small businesses may have declined.

In the last two years, banks have experienced improved asset quality and record profits. As a result, the banking system is in a position to increase lending activity. Banks are better able to play their traditional role in the financing of the economy, a development which should prove beneficial to the small business sector. Our surveys, in fact, have indicated that many banks have eased their loan standards somewhat in recent months, especially for smaller business borrowers. I should point out as well that our surveys also indicate that demand for credit remains slack.

Nonetheless, various reports suggest that some smaller businesses are having difficulty obtaining credit, especially in areas experiencing economic difficulty. Their problems may be, in part, due to regulatory practices, or to perceptions of regulatory policies. Accordingly, the Federal Reserve and the other bank supervisory agencies recently have implemented a number of initiatives designed to facilitate the availability of credit to creditworthy borrowers. These initiatives are intended to result in an increase in credit availability to all borrowers. Some of these initiatives were designed particularly to benefit smaller business borrowers.

Specifically, in March, the federal supervisory

agencies initiated a program to allow banks to establish a "basket" of loans which will be judged on the basis of performance, and not be criticized on the basis of documentation deficiencies. The Federal Reserve believes that some small business loans which may not have been made because of a fear of regulatory criticism, may now be extended in a manner consistent with safe and sound banking and with banks' traditional underwriting practices. While not enough time has passed to permit a large number of these loans to be made, we understand that a number of banks currently have this opportunity under consideration. After the banking agencies gain experience with the program, we will review whether sound, well-managed banks can be given even greater latitude to utilize the "basket."

Another important initiative is the agencies' proposal to increase from $100,000 to $250,000 the threshold amount below which real estate-related loans do not require FIRREA Title XI appraisals. Raising the threshold should reduce the documentation burden and expense associated with loans to small businesses that are collateralized wholly or in part by property.

A possible avenue to increase credit availability to the small business sector (and the focus of Senate bill S.384) could be the expansion of opportunities to securitize small business loans. While no panacea, this approach has been given increased consideration in recent years.

In a securitization, loans are placed in a pool and securities are issued that entitle the holders to the proceeds of the principal and interest payments flowing from the underlying loans. Originators of loans that are used in asset-backed securities could benefit from improved liquidity, enhanced fee income, and--to the extent that a true sale has occurred and the assets are removed from their balance sheets--less need for capital. Investors, on the other hand, acquire securities that require no management of the underlying loans on their part and yet provide an attractive return for instruments that pose, depending upon the nature of the credit enhancement, little or no credit risk.

Both sales and purchases of securitized pools, then, offer improved diversification and a greater selection of risk and return alternatives. Purchases of securities backed by loans may be particularly valuable to smaller banks that do not have the capability of geographically diversifying their lending or diversifying according to industrial sector.

Given the potential benefits to be gained from the securitization of small business loans and business loans generally, the Federal Reserve believes that it is important to give careful consideration to all proposals designed to promote and encourage the securitization of such loans. These potential benefits have been dramatically demonstrated by the impressive

growth in the residential mortgage-backed securities market and the markets for securities based on auto loans and other consumer loans. It thus seems reasonable that small business lending could also benefit from securitization.

The nature of small business loans, however, differs substantially from the types of loans--such as residential mortgages, auto loans, and credit card receivables--that are currently securitized. While these types of loans are relatively homogeneous, small business loans tend to be quite heterogeneous in nature, in part due to the natural diversity of small business enterprises and individually negotiated loan terms designed to suit the unique credit needs of each borrower. This diversity manifests itself in loans with widely different maturities and repayment terms, different degrees of documentation, and different amounts of information regarding the underlying financial positions of the obligors. This heterogeneity greatly complicates the process of predicting the future cash flows produced even by pools of the highest credit quality.

Also, small business loan pools may exhibit a diversity in credit quality, which coupled with a diversity in documentation standards, greatly complicates the task of performing due diligence and reaching a judgement as to the overall quality of the pool. Finally, the lack of a sufficiently broad and deep historical data base on small business loan

performance makes actuarial methods of estimating loan losses extremely difficult.

These difficulties, which in and of themselves represent barriers to successful widespread securitization of small business loans, tend to cause securities markets to require substantial credit enhancements on small business loan pools. At the same time, the special nature of small business loans makes it relatively difficult for banks to accurately assess the riskiness of issuing such credit enhancements. Thus, it is especially important to assure that banks maintain capital at a level commensurate with their risk exposure both to loans they have sold into pools and to the pools they have acquired. Capital should be held where risk exposure exists, and banks selling assets with substantial first loss recourse continue to be exposed to risks related to the assets. Under such first loss arrangements, a bank selling assets with recourse commits to cover any initial losses on loans that may occur up to a contractually agreed upon amount. This results in the selling bank being exposed to a possibly significant proportion of the potential losses on the transferred loans.

Another point that needs to be made regarding the securitization process is that banks are likely to select loans of higher quality for sale into loan pools and to retain loans of lower quality in their portfolios. Accordingly, if this process

is repeated over time, it can lead to a significant decline in the credit quality of loans held on the balance sheet. If such deterioration does occur, the portfolios would be subject to greater supervisory scrutiny, and the capital held against these loans would have to be bolstered.

Under generally accepted accounting principles (GAAP)--or more specifically financial accounting standard (FAS) 77--which the bill as introduced proposed to utilize, a bank may remove from its balance sheet an asset sold with recourse even if it has retained the risk of ownership. This accounting standard treats the transfer of assets with recourse as a sale if the seller relinquishes the benefits of owning the asset, is reasonably able to estimate the expected losses to which it is still exposed under the recourse provision, and establishes a specific liability reserve equal to the amount of these expected losses. This treatment generates a strong incentive for banks to underestimate losses, and this weakness has caused some accounting professionals to criticize FAS 77. However, even if accurate loss estimates were used, this approach would still be of concern from a supervisory perspective because it does not take into account the possibility that actual losses may turn out to be substantially greater than expected losses. The role of capital is to serve as a buffer against such developments, and GAAP is silent on this aspect of risk exposure.

The banking agencies' rules attempt to establish policies to ensure that government-insured depository institutions will hold capital commensurate with their risk exposure in any transactions--including securitized transactions--that they engage in. Thus, unlike GAAP, the regulatory treatment of asset sales focuses on the retention of risk rather than the relinquishing of the benefits of ownership. Under this treatment, when a loan is transferred with recourse, the agencies have generally treated the transaction as a borrowing and required the transferor to maintain capital against the entire amount of the assets transferred.

In recent years, however, it has come to be recognized that this conservative approach does not fully take into account contractual limitations on the selling bank's recourse obligation and may not accurately reflect expectations or practices of the marketplace. Accordingly, the agencies, under the auspices of the Federal Financial Institutions Examination Council, have been reviewing existing recourse rules. They have concluded that these rules should be modified to reduce the capital charges for certain asset sales with limited recourse in order to make those charges more commensurate with the contractual credit risk to which the selling organization is exposed. We plan to issue a detailed proposal for public comment in the near future. Although the specifics of the new recourse rules are not yet concrete, the new guidelines that the Federal Reserve ultimately

administers will be consistent with the basic supervisory principle that the capital held against transactions should be commensurate with their risk. I would note that while the existing regulatory guidance is in need of revision, its limitations have not precluded the development of substantial securitization markets for other types of loans.

As I said earlier, we support the overall objectives of S.384. The bill places a reliance on the private sector to develop the secondary market for small business loans, and we find that aspect of the bill attractive. It is imperative that we avoid adding to the already enormous volume of government liabilities by creating an additional government agency, or increasing the involvement of existing government agencies, in the securitization of small business loans.

One of the most important safety and soundness considerations is the amount of capital that is maintained to protect banking organizations from any risks associated with loan securitization. The bill as introduced contained capital provisions that in our view would not provide adequate protection to banks involved in securitization. While we have not seen a final version of this bill, discussions between the staff of this Committee and the banking agencies have identified alternative approaches that represent some relaxation of current standards. These approaches could be acceptable so long as they are properly

structured and accompanied by appropriate prudential and safety and soundness limitations. For example, we understand that current drafts of the bill, in order to encourage the securitization of small business loans, would give designated institutions permission to maintain capital against risk exposure arising from the sale of small business loans with first loss recourse in an amount that is less than is required under the banking agencies' existing capital standards.

We also understand that important limitations are incorporated in current drafts of the bill that help mitigate safety and soundness concerns. First, the preferential treatment would be restricted to those institutions that, under current capital standards, are either well capitalized or are adequately capitalized and have the approval of their primary regulator. Second, there is a major limitation placed on the aggregate amount of retained recourse that is eligible for the preferential treatment. So long as these limitations are appropriately specified, we do not believe that the approach in the bill, as we understand it, would threaten safety and soundness conditions, while it may encourage securitization and the availability of credit to small business firms. Obviously, we would want to reserve final judgment on these safeguards, and other provisions of the bill, until we have had an opportunity to review the actual language of the bill and its consistency with the fundamental prudential principles underlying U.S. and

international capital standards.

As I mentioned earlier, the banking agencies have underway a broad-based review of our capital standards for securitization and other recourse arrangements. We believe that rather than specifying detailed capital requirements for a select group of assets by statute, it would be preferable for Congress to fashion legislation directing the agencies to develop appropriate capital standards for securitizing small business loans. This would enable the agencies to address small business loan securitization in a manner that would be consistent with the prudential framework for securitization more generally. Such an approach is preferable for economic efficiency and bank safety and soundness. It would also avoid the rigidities that result when technical and complex regulatory requirements are written into law. The agencies need flexibility in order to be able to adjust the rules to later experience in the market.

In view of the importance of credit availability to small- and medium-sized businesses, we are committed to continuing to work with this Committee, the other banking agencies and the Administration in developing an approach that will remove any unnecessary impediments to securitization, while at the same time protecting the safety and soundness of the banking system.