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Testimony by

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I am here today to discuss Title II of the Community Development, Credit Enhancement, and Regulatory Improvement Act of 1994 (H.R. 3474), entitled Small Business Capital Formation, as passed by the Senate on March 17, 1994. Title II 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 some small businesses have had in obtaining adequate credit accommodation. Moreover, experience in other sectors of the credit markets where securitization has become widespread suggests that securitization of small business loans could confer benefits on banks and other financial institutions that originate, securitize, and invest in these loans.

Accordingly, the Federal Reserve supports the objectives of Title II. We believe that its implementation may 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.

Small- and medium-sized businesses have always been of critical importance to the American economy. They have served as an engine for job creation and as a major source of innovation in product development. For these businesses to continue to fulfill these roles they must have the 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 the banking industry.

Unfortunately, during the latter part of the last decade, and in the first year of this decade, as banks encountered severe problems in their loan portfolios, they generally tightened their lending standards. As a result, the availability of credit was significantly reduced, particularly to small businesses. With its markedly improved performance in the past two years, the banking system has been able to strengthen its balance sheet and is in a much better position to lend to small businesses and other borrowers. Government agencies have also taken a number of steps to encourage banks to loan to small businesses including 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. Taking these developments into account along with the generally improving economy, it is not surprising that the volume of small business loans has been growing since last fall.

Nonetheless, there may be many situations in which creditworthy small businesses are continuing to encounter difficulties in obtaining credit. In addition to addressing the

problem created by the credit crunch of recent years, it is highly desirable to find ways to promote, in an efficient but prudential manner, the flow of credit to smaller businesses.

A possible way to maintain or increase small businesses' access to credit 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.

In order for the securitization of assets to be successful, the resulting security must be appealing to investors, who are generally risk-averse. When evaluating

securities, investors rely heavily upon the national credit rating agencies to inform them of the credit risk associated with securities through the assigned credit ratings. Thus, securitized transactions must have sufficient credit enhancement to obtain a credit rating level that makes the securities attractive to investors.

Both sales and purchases of securitized pools 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 diversifying their lending either geographically or 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 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.

Small business loans, however, differ 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, due in part to the natural diversity of small business enterprises and their loan terms, which are usually individually negotiated to suit the unique credit needs of each borrower. This diversity results 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 by pools of even 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.

All of these barriers to successful widespread securitization of small business loans derive from the heterogeneity of this type of credit. The heterogeneity problem

could be solved through a more standardized loan product that could be easier to securitize. Standardization, however, would introduce an element of inflexibility into small business lending and could preclude many small business firms from obtaining the credit accommodation they need because they do not fit the "mold." In addition, the standardization of small business loans could increase the amount of documentation needed to support such credits, thereby increasing the cost to small business borrowers.

In this regard, it should be noted that the securitization of residential mortgages has resulted in much more elaborate and expensive documentation requirements. Thus, it is possible that rigid and inflexible underwriting standards and increased documentation requirements could actually curtail the amount of available credit for businesses.

Because greater homogeneity of small business loans has not been achieved, the successful securitization of such assets has had to rely upon significant credit enhancements. Such large enhancements are needed to offset the concerns of risk-averse investors over the uncertainty associated with the heterogeneous nature of small business loans.

The provision of credit enhancements by banks to facilitate the securitization of these loans is certainly not an objectionable activity, so long as it is carried out in a safe

and sound manner and adequate capital support is maintained to protect depositors. In this connection, it should be noted that the heterogeneous nature of small business loans makes it relatively difficult for banks to accurately assess the riskiness of providing credit enhancements for these transactions. Thus, it becomes especially important to ensure that banks maintain adequate capital for such arrangements, including sales of assets with recourse.

Under a recourse arrangement, a bank typically 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.

Under generally accepted accounting principles (GAAP)--or more specifically Financial Accounting Standard 77 (FAS 77)--which the bill proposes 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 loss estimates were made in good faith, 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 have required the transferor to maintain capital against the entire amount of the assets transferred.

More recently, 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. In this regard, the agencies, under the auspices of

the Federal Financial Institutions Examination Council, have reviewed longstanding 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.

Accordingly, on May 25, 1994, the federal banking agencies published for public comment a detailed proposal on the appropriate capital treatment for recourse arrangements. The proposed guidelines are consistent with the basic supervisory principle that the capital held against transactions should be commensurate with their risk. In particular, the agencies are proposing to reduce the capital requirement for all recourse transactions where the selling banking organization contractually limits its exposure to less than the full, effective risk-based capital requirement for the assets transferred. This low-level recourse rule would apply to all types of assets, including small business loans and commercial loans. For example, the risk-based capital requirement for a standard risk asset transferred with a 3 percent recourse obligation would be only 3 percent rather than the currently required 8 percent.

In addition, the agencies are requesting public comment on a preliminary proposal that would employ credit ratings to assess risk-based capital against banking organizations'

securitization exposure based on their relative risk of loss from the underlying assets. This aspect of the agencies' proposal could reduce the capital requirement against senior asset-backed securities that currently are assessed 8 percent capital. I would note that while the existing regulatory guidance is in need of some revision, its limitations have not precluded the development of substantial securitization markets for a wide variety of loans.

In this regard, in the House version of H.R. 3474, section 138 calls for federal banking agencies to review the capital standards applicable to loans sold with recourse and revise their capital standards in accordance with the agencies' findings. The banking agencies are already conducting such a review and, as mentioned earlier, recently published proposals to revise their capital rules with regard to recourse arrangements as a part of that review. Thus, it would seem that legislative action calling for such a study is not necessary.

Section 138 also mandates that any revisions that the agencies propose to their capital standards may not be less stringent than GAAP. This explicitly ties the banking agencies' regulatory capital rules to GAAP. The capital rules are not an accounting principle; they are a supervisory tool to help ensure the safety and soundness of the banking system. On the other hand, GAAP -- as set by the Financial Accounting Standards Board

(FASB), a private standard-setting group -- is oriented toward the disclosure of information for stockholders, investors, and analysts, which may or may not be relevant for safety and soundness purposes.

Given the divergent purposes of the regulatory capital rules and GAAP, we believe that the banking regulators should have the authority to differ from GAAP when necessary in order to address safety and soundness concerns without being constrained by a stringency test relative to standards set by a private group like FASB. The section 138 stringency test is similar to the one set forth in section 121 of the Federal Deposit Insurance Corporation Improvement Act (FDICIA) with respect to accounting standards banking organizations must use in completing regulatory reports, and both cause concern.

Section 138 of the House version of H.R. 3474 effectively would give FASB more authority over the agencies' regulatory capital rules than the regulators themselves would have -- just as section 121 of FDICIA has given FASB more authority than the agencies have over regulatory reporting requirements -- since in both cases any differences from GAAP would have to be justified as "no less stringent." This is of concern to us because safety and soundness considerations may dictate an approach to regulatory capital rules and regulatory reporting that is very different from what GAAP requires and,

thus, a stringency test may not be applicable. As a result, the banking regulators may be forced to follow GAAP in cases where that is not the prudential course of action from a safety and soundness viewpoint, simply because that course of action is so different a stringency test cannot be applied.

Accordingly, section 138 of the House version of H.R. 3474 should be either dropped or revised to decouple the agencies' regulatory capital rules from GAAP. Further, we would propose that Congress also amend section 121 of FDICIA so that the agencies' regulatory reports can follow GAAP to the extent consistent with safety and soundness.

Now I would like to turn to the specifics of section 208 of Title II, which deals with the accounting, capital and reserve requirements for transfers of small business loans. In particular, with respect to capital, section 208 contains two principal provisions. First, small business loans sold with recourse would be reported in accordance with GAAP on the regulatory reports filed by insured depository institutions. Second, the maximum amount of capital and reserves to be maintained by insured depository institutions selling small business loans with recourse would be limited to a specific reserve equal to the selling institution's reasonable estimate of its liability under the recourse arrangement, plus an 8 percent capital requirement against the amount of retained recourse.

As I have noted, 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. In our view, the capital provision outlined in section 208 of Title II accords quite preferential treatment to the securitization of small business loans. If that treatment were to be extended to small business loan securitizations without imposing limitations it would raise safety and soundness concerns. However, the bill incorporates some limitations which help somewhat to mitigate these safety and soundness concerns. First, the preferential capital treatment would be restricted to those institutions that, under the agencies' current risk-based capital standards, either are well capitalized or are adequately capitalized and have the approval of their primary regulator. Second, the aggregate of the maximum contractual recourse obligations on all such loans "sold" may not exceed 15 percent of a bank's total risk-based capital.

While we do not believe that the approach specified in Title II is the best way to manage this activity, we did not object to the approach or believe that it would unduly threaten safety and soundness so long as these limitations were in place and the preferential capital treatment was limited to small business loans. However, we are concerned that establishing a special capital treatment for small business loans would set a troubling precedent for other types of loans and that the

extension of the liberal treatment beyond small business loans could raise safety and soundness concerns.

As I mentioned earlier, the banking agencies have issued specific proposals to revise our capital standards for securitizations 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 revise this legislation to support the agencies' efforts to develop appropriate capital standards for securitizing all types of loans. This would enable the agencies to address small business loan securitization in a manner that would be consistent with the maintenance of a safe and sound banking system. 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 account for changes that occur in the marketplace.

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 and minimizing regulatory burden.

In our view, the capital provisions outlined in section 208 of Title II would not, by themselves, provide adequate protection to banks involved in securitization of small business loans. For example, in order to encourage the securitization of small business loans, section 208 of Title II 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 or proposed capital standards.

Congress now has before it several other bills that would extend this preferential capital treatment to a wide variety of assets that are even more difficult to securitize than small business loans. We believe that such an expansion would be unwise. Most certainly, lending that would be subject to liberal capital terms should not be expanded beyond the constraints that have been specified. That being the case, to the extent other types of loans are made eligible for such treatment, that would require a reduction in the amount of small business loans that could be sold under the liberal capital terms. Moreover, to widen the list of eligible loans would serve to complicate an already complex capital standard. And, such an extension is almost certain to be perceived as a major departure from the established internationally-accepted capital principles, upon which the U.S. banking agencies have based their risk-based capital rules.