

ECONOMIC COMMENTARY

Federal Reserve Bank of Cleveland

The Evolving Loan Sales Market

by Joseph G. Haubrich and James B. Thomson

Nearly everyone, from daily readers of the *American Banker* to devotees of *It's a Wonderful Life* or *Bonnie and Clyde*, somehow learns a few basic facts about banking. Most people know that a bank accepts deposits and uses the money to make loans. Many people believe that if too many depositors want their money back at once, the bank will fail. What would people think if they knew banks could make loans without taking in deposits, and sell loans when depositors want their money returned?

The loan sales market allows just that. This practice may only mildly inconvenience Hollywood producers, but it raises deeper and more fundamental questions for bankers and policymakers.

Traditionally, policymakers have viewed banks as "special" because they invest primarily in highly illiquid assets and, by and large, finance these assets with extremely liquid liabilities—checkable deposits. Bank portfolios, which consist of illiquid loans, are difficult to value and costly to liquidate. This makes banks a vital resource for the important small-to-medium-business sector. But the ability to fund high-information assets comes at a cost. Depositors, especially small savers, may find it difficult and expensive to evaluate the quality of bank assets. Therefore, in lieu of routinely monitoring the institution to protect themselves from loss, they rely on their ability to cash out their deposits at the first sign of trouble.

Thus, the consequence of funding illiquid, information-intensive loans with liabilities that are essentially "payable on demand" is a banking system that is vulnerable to runs, panics, and systemic collapses. This "banks are special" view is the rationale for government supervision and regulation of banks, including federal deposit insurance and Federal Reserve discount window operations.¹

The existence of loan sales modifies the traditional view in three ways: 1) a bank can reduce the need for deposits by selling its loans; 2) a bank can sell the now-liquid loans when it needs cash; and 3) a widely observable price for loans makes it easier for small depositors to ascertain the true health of their bank.

From the banker's perspective, loan sales offer both the possibilities of profit and the danger of a decline in the importance of banks. A small bank with few deposits or low capital can turn over a large number of loans, collecting the origination fees and pocketing the sales profits. A bank of any size can buy loans to diversify its portfolio, becoming less dependent on the ups and downs of local industry. On the other hand, loan sales imply an unbundling of the origination and investment functions of bank lending and a reduction in the advantages associated with funding loans with deposits. To the extent that this erodes the competitive advantage of banks in lending markets,

The loan sales market, which reached a peak in the latter half of the 1980s, remains substantial despite the recent recession and the falloff in merger and acquisition activity. Does this emerging market reflect a dispersal of traditional banking services or an expansion of banks' fundamental role as financial intermediaries? In either case, the answer should lead to further analysis of the rationales for federal deposit insurance and bank regulation.

loan sales reduce the size and importance of the banking industry.

Yet, if it's so easy to make and sell loans, why haven't Wall Street firms replaced banks in this market, just as commercial paper has replaced short-term bank loans to Fortune 500 firms? Do banks sell loans because they have new ways to signal their traditional proficiency in monitoring and evaluating them as a result of advances in information and communications technology? Or is it simply because regulation has made such sales profitable? The answers to these questions will help us to determine whether loan sales indicate a dispersal of traditional banking services or represent an expansion of banks' fundamental role as financial intermediaries. In either case, all of us—scholars, regulators, managers, and customers—must rethink what a bank does, as well as how it is supervised, regulated, and protected.

In this *Economic Commentary*, we hope to stimulate that discussion by examining the loan sales contract itself and the impact of legal and accounting issues in shaping the loan sales market. By documenting the market's growth during the second half of the 1980s and its subsequent downturn in the early 1990s, we try to establish who buys and sells loans, how mergers and acquisitions affected the market, and what impact the 1990–91 recession had on loan sales.

■ The Loan Sales Contract

When a bank makes a loan, it creates an asset: the promised future payments by the borrower.² When the bank sells the loan, it transfers these promised payments to the buyer, who then assumes all of the default and interest-rate risk. Loan sales contracts typically fall into one of three categories based on the role of the selling bank after the sale occurs. Regardless of type, a loan sale removes the loan from the selling bank's balance sheet for both regulatory and accounting purposes.

The most common type of loan sale is the *participation*. Here, the originating bank continues to hold the formal contract between the bank and the borrower. The selling bank collects payments, oversees the collateral, and examines the books. In many cases (termed silent participations), the borrower does not even know the loan has been sold.

A less common but still important type of loan sale, the *assignment*, transfers the debtor–creditor relationship to the loan buyer. This gives the purchaser some rights to take direct action against the borrower in the event of nonperformance or default. Assignments do not completely remove the original bank from the picture. It may retain obligations to the borrower, such as loan commitments, or hold the lien on any collateral backing the loan.

The rarest, and most complete, type of loan sale is the *novation*. Like the sale of a stock or bond, a novation completely transfers all rights and obligations of the selling bank to the buyer, and the originator leaves the picture entirely.

Except in the case of novations, then, selling a loan is less of a “clean break” than is the sale of some other asset, such as a bond or a house. Although in certain types of sales the originating bank retains some relation with the firm—such as serving as a conduit for payments and balance-sheet information—regulators will allow a bank to remove a loan from its books only if the buyer shoulders all of the associated risk. Otherwise, the bank must hold capital against the loan even though it has been sold. Therefore, to obtain the full advantages of a sale, the entire loan must be sold off, the bank can provide

no recourse to the buyer, and the loan must be sold to maturity (for example, the bank cannot sell only the first 15 years of interest on a 30-year loan).³

Selling loans creates a potential problem for banks. These products, now marketable, increasingly resemble traditional securities such as bonds and debentures. Banks don't want loan sales to be classified as securities, because they hope to avoid federal securities regulation and the associated disclosure laws, reporting requirements, and tougher set of legal standards. Furthermore, they need to steer clear of the Glass–Steagall prohibitions against underwriting securities.⁴ The courts have generally held that loan sales are not securities, in part because banks have taken pains to structure the contracts properly. For example, once sold, loans are rarely resold, because such a transaction would make them seem too much like a security.

■ Market Participants: What They Sell, Who Buys, and What They Pay

Slightly more than one-third of all banks sell loans. Larger banks predominate in the volume of total loans made as well as in the volume of loan sales. The type of loans sold has changed over time, in both maturity and quality. In the early 1980s, banks mainly sold short-term (under 90 days) domestic commercial and industrial loans to investment-grade (BBB or better) borrowers. However, the average maturity of loans sold has lengthened as the market has developed. As of June 28, 1993, the nine major banks tracked by the newsletter *Asset Sales Report* had \$58.94 billion of loans sold outstanding, of which only \$6.46 billion had maturities of less than a year. The

TABLE 1 LOAN SALES BY TYPE OF PURCHASER, 1987-92
(Billions of dollars)

	1987	1988	1989	1990	1991	1992
Domestic banks						
< \$2 billion in assets	2.7	3.2	2.4	20.7	0.1	3.2
> \$2 billion in assets	10.7	14.2	22.2	9.4	0.9	21.6
Foreign banks						
Agencies and branches	14.8	16.7	30.1	26.1	5.1	19.8
Offices	n.a.	6.9	2.5	4.7	0.8	2.5
Nonfinancial corporations	1.9	3.2	4.8	6.3	0.7	3.8
All other	6.7	9.0	9.9	13.0	0.1	4.0
Total	38.7	53.1	72.2	80.2	7.7	54.9
	Percent					
Share of loans to investment-grade borrowers	45.8	39.9	34.8	44.1	18.0	59.0
Share of loans for financing mergers and acquisitions	34.6	23.1	44.5	37.5	22.0	23.0
Share of loans purchased by foreign banks	38.2	44.4	45.2	38.4	76.9	40.6

SOURCE: Senior Loan Officer Opinion Survey on Bank Lending Practices, August issues from 1987 to 1992.

lengthening of maturities has been accompanied by a pickup in sales of loans to lower-quality borrowers. With the exception of 1992, in every year since 1987 less than half of all loans sold by banks in the Federal Reserve's *Senior Loan Officer Opinion Survey* were obligations to investment-grade borrowers (see table 1).

Major buyers of loans include other banks (foreign and domestic), nonfinancial corporations, and other nonbank financial intermediaries, such as insurance companies and pension funds. Banks reporting loan sales on the *Senior Loan Officer Opinion Survey* indicated that from 1987 to 1992, foreign banks purchased more than 42 percent of all loans reported as sold. Domestic banks were the next-largest buyers of loans, accounting for more than 36 percent of sales, with nearly 26 percent purchased by large domestic banks (assets exceeding \$2 billion) alone.

An integral aspect of this market is its pricing structure. Prices of highly rated loans closely track those of commercial paper and the London Interbank Offering Rate (LIBOR). Not surprisingly, yields on lower-rated loans show a greater spread. The February 1, 1993, issue of *Asset Sales Report* lists the spread between the 30-day A1/P1 (highest-rated) loan sales yield and commercial paper as -2 basis points, showing that short-term loan sales can even sell at a premium to commercial paper. For loans with a lower rating, A2/P2, the spread was 18 basis points.⁵

■ Recent Trends and Their Causes

No story about the loan sales market would be complete without a chapter on its dramatic growth during the mid-1980s and its sudden decline around the turn of the decade. Fully comprehending the implications of loan sales for financial intermediation requires an

understanding of what factors or events led to the surge in loan sales, and whether they were related to advances in communication and information technology or driven by regulatory and legal changes in the development of this market.

To track the market's performance, we use data on loans sold and purchased by banks covered by the Federal Deposit Insurance Corporation's *Bank Insurance Fund*. Our main sources are the Federal Financial Institutions Examination Council's *Quarterly Reports on Income and Condition*, or "call reports." The data on loan sales extend from March 1984 to December 1992. Loan purchases start later, in June 1987.

Figure 1 plots the aggregate level of loans sold and purchased. Note the explosion in the loan sales market between 1986 and 1988 and the subsequent collapse from 1989 to 1991. Loan purchases, though much smaller than sales (because many firms other than domestic banks purchase loans), remained fairly steady over the entire period. Similar patterns emerge when we plot sales and purchases as a percentage of net loans and leases. The tremendous growth and subsequent decline in loan sales were thus not the result of variation in the volume of loans outstanding.

Economic activity certainly played a role in the market's rise and fall. The spectacular upturn in loan sales occurred during the longest peacetime economic expansion in U.S. history, and the peak of the market, in 1989, arrived just before the 1990-91 recession. However, though the initial downturn may have come as a cyclical response to the recession, loan sales have continued their decline during the ensuing recovery. Bank purchases have remained steady at a somewhat lower level. Therefore, there appears to be

FIGURE 1 LOAN SALES AND PURCHASES, 1984-93



SOURCE: Federal Financial Institutions Examination Council, Quarterly Reports on Income and Condition, 1984 to 1993.

much more to this story than can be explained by economic fluctuations.

One familiar version attributes the growth and decline of loan sales to the boom and bust in the market for mergers and acquisitions (M&A) during the 1980s. Banks did provide an important source of funding for this market and did routinely sell large M&A credits as participations in the past decade. Moreover, the falloff in M&A activity, particularly in leveraged buyouts (LBOs), exhibits a pattern broadly similar to that of the loan sales market.

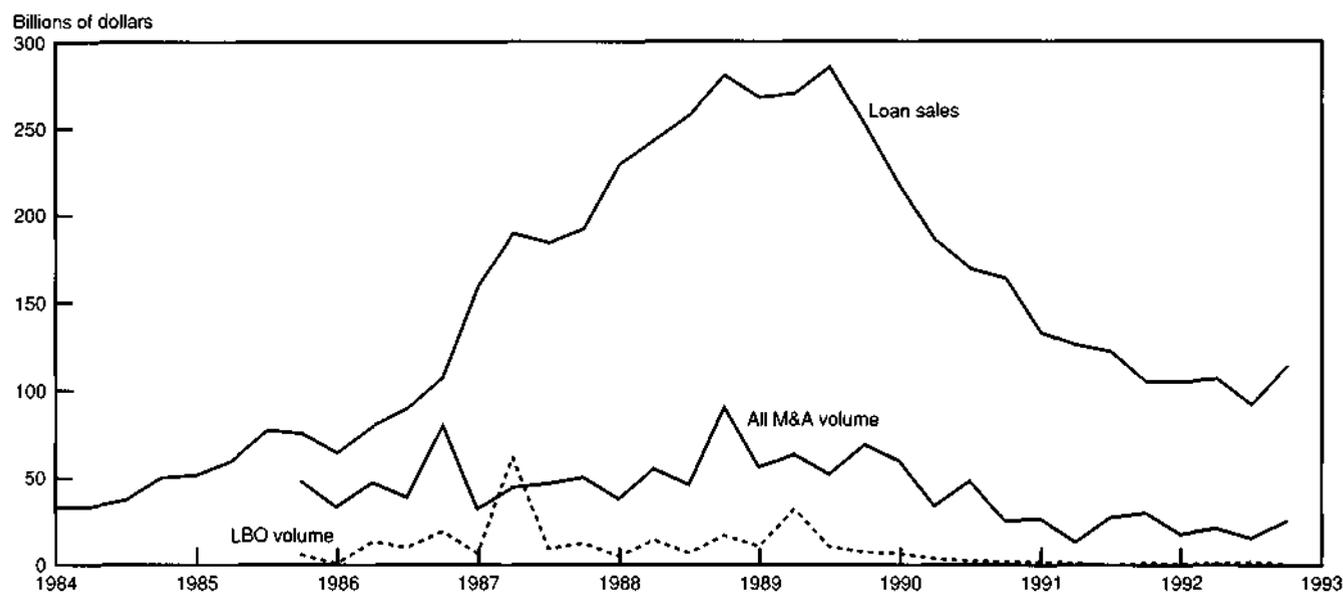
Table 1 shows that for banks participating in the *Senior Loan Officer Opinion Survey*, the M&A market story holds some validity. For the overall market, however, merger-related lending cannot explain the pattern of loan sales volume. Figure 2 plots loan sales and total M&A activity.⁶ The M&A series overstates bank involvement in this market because banks were not the sole funding source. Even so, the level of this activity is simply too small to account for either the rise or the drop in loan sales

volume. A closer look at figure 2 suggests that mergers could have played a major role before 1987, when the market first developed, but not since.

Other determinants, such as regulation and the institutional structure of banks and banking markets, are harder to pin down. A recent study of ours provides some insights into these additional factors.⁷ In that paper, we find that a bank's organizational structure, its investment decisions, and its financing strategies are important influences on its loan sales activity. Consider, for example, the negative relationship between loan sales and bank capital. By selling a loan, a bank with low capital avoids both the minimum capital requirement and the need to raise more capital. The burdens of regulation thus provide a motive to sell loans. On the other hand, banks with an abundance of local deposits and a strong capital base tend to buy loans.

The evidence also suggests that loan sales are a response to the prohibitions on interstate branching, which limit bank access to local deposits as well as hinder geographic diversification of assets and liabilities. We find that banks that have trouble acquiring enough local deposits often sell loans and that there is a regional pattern to both loan sales and loan purchases. Corroborating evidence comes from the positive relation between bank holding company (BHC) status and loan activity. Currently, interstate expansion requires a BHC to own separately chartered banks in each state. Loan sales and purchases, in turn, are a critical tool for managing a BHC's balance sheet. This market allows the BHC to move assets across its subsidiaries, minimizing funding and regulatory costs by matching loans and deposits across these separately chartered units. Such asset reallocations would not be necessary if banks could branch across state lines, since a branch bank faces only a single balance-sheet constraint.

FIGURE 2 LOAN SALES AND MERGER AND ACQUISITION ACTIVITY, 1984-93



SOURCES: Federal Financial Institutions Examination Council, Quarterly Reports on Income and Condition, 1984 to 1993; and *Mergers and Acquisitions*, various issues.

Finally, while our study indicates that these institutional factors significantly influence loan sales and purchases, additional factors that are harder to quantify must account for the bulk of the market. These most certainly include advances in information and communications technology and changes in the legal environment that have made loan sales feasible. Moreover, loan sales appear to be a natural product for banks that specialize in merchant banking and high-tech finance, such as Morgan Guaranty Trust and Bankers Trust.

■ Conclusion and Policy Implications

Even though the current volume of loan sales has dropped to less than half its peak, the market remains substantial (about \$120 billion in 1992:IVQ). The market's continuing force, coupled with the meager actual effects of theories predicting its demise (such as the collapse in M&As), implies that loan sales will not fade from the financial landscape. Additional evidence is found in the market trend away from short-term

loans made to investment-grade borrowers toward long-term loans made to noninvestment-grade companies.

From a public policy perspective, understanding the loan sales market helps all of us to realize how banking is changing and requires us to rethink our rationales for both the federal safety net and bank regulation. Fundamentally, loan sales lead us to reevaluate the reasons for making banks special. The government's role as lender of last resort via the discount window presupposes a need to convert illiquid bank loans into liquid assets. The loan sales market allows banks to make such a conversion on their own, and in some cases may substitute for discount window lending.

Similarly, to the extent that this added liquidity makes banks less vulnerable to panic attacks, the need for deposit insurance is lessened. The current loan sales market, concentrated among larger banks and untested by a financial panic, cannot replace either the discount window or deposit insurance.

Still, in the search for the best and most efficient financial regulation, this market progression may suggest a more gradual evolution in policy.

A further policy concern is that similarities between loan sales and securities point to increasing competition between banks and other financial institutions and a further blurring of the lines that separate them. Bank loans look more like securities—more likely to be bought and sold—while some financial firms seem more like banks after buying and holding portfolios of bank loans. Thus, one must assess the degree to which regulation treats similar firms similarly, and the extent to which bank regulation and the access of banks to federal deposit insurance places them at a competitive advantage or disadvantage to other financial firms.

■ Footnotes

1. For a contrary view of the efficacy of bank runs, see George G. Kaufman, "The Truth about Bank Runs," in Catherine England and Thomas Huertas, eds., *The Financial Services Revolution: Policy Directions for the Future*. Boston: Kluwer Academic Publishers, 1988, pp. 9-40. For arguments against the "banks are special" hypothesis, see Anthony B. Saunders and Ingo Walter, "Are Banks Special?" *Journal of International Securities Markets* (Winter 1987), pp. 1-17.

2. Loan sales represent the sale of a single asset, rather than a pool of assets, and in that sense differ from asset securitization. For a discussion of securitization, see Charles T. Carlstrom and Katherine A. Samolyk, "Securitization: More than Just a Regulatory Artifact," Federal Reserve Bank of Cleveland, *Economic Commentary*, May 1, 1992.

3. For more detail, see Gary B. Gorton and Joseph G. Haubrich, "The Loan Sales Market," in George G. Kaufman, ed., *Research in Financial Services: Private and Public Policy*, vol. 2 (1990), pp. 85-135; and David M. Morris, "Accounting for Commercial Loan Sales," in Jess Lederman et al., eds., *The Commercial Loan Resale Market: A Banker's Guide to Selling Commercial, Industrial, and LBO Debt*. Chicago: Probus, 1991, pp. 99-130.

4. A concise yet accurate description of these prohibitions can be found in Kenneth Spong, *Banking Regulation: Its Purposes, Implementation, and Effects*, 3rd ed., Federal Reserve Bank of Kansas City, 1990, pp. 71-76.

5. An A1 rating is the highest investment-grade rating for short-term paper given by Standard & Poor's. Similarly, a P1 rating is the highest investment-grade rating for short-term paper given by Moody's. An A2/P2 rating is the second-highest investment-grade rating for short-term paper from these agencies.

6. The latter data are gleaned from various issues of *Mergers and Acquisitions* from 1986 through 1993.

7. See Joseph G. Haubrich and James B. Thomson, "Loan Sales, Implicit Contracts, and Bank Structure," *Proceedings from a Conference on Bank Structure and Competition*. Federal Reserve Bank of Chicago (forthcoming 1993).

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