

published: 9.16.98

September 16, 1998

Mr. John L. Gray
Associate Deputy Administrator for Capital Access
U.S. Small Business Administration
409 Third Street, S.W.
Suite 8200
Washington, D.C. 20416

Dear Mr. Gray:

On behalf of the Government Business Loan Committee (the "Committee") of The Bond Market Association, (the "Association"),¹ this letter sets forth the Committee's views and recommendations regarding several important issues relating to the operation of the secondary market for debt obligations guaranteed by the Small Business Administration ("SBA"). It is intended to serve as a more detailed follow-up on several of the matters that were discussed when members of the Committee met with you in Washington, D.C. last April, as well as in subsequent conversations that Committee members and I have had with various SBA staff. We appreciate the opportunity to communicate with you on these matters of mutual interest and concern.

INTRODUCTION

The Committee is composed of securities firms and banks, located throughout the United States, that actively participate in the secondary market for government-guaranteed debt obligations. In the case of debt obligations guaranteed by SBA, our activities principally consist of buying and selling loans originated under the SBA's Section 7(a) loan program ("7(a) loans"), as well as certificates representing beneficial interests in pools of such loans ("pool certificates"), including interest-only ("IO") strips of such loans. The firms represented by members of the Committee are collectively responsible for the vast majority of secondary market trading activity involving various types of government guaranteed debt obligations, including those originated pursuant to lending programs administered by SBA.

The SBA has traditionally focused its programs, activities and resources on small business borrowers and lenders, in keeping with its mission to aid, counsel and assist the credit and capital formation needs of small businesses. However, it is important to recognize that secondary market participants, including the Association's broker-dealer and bank members, serve a vital role in the small business capital formation process. Ultimately, the secondary market supplies the capital that lenders use to originate new loans to small businesses. A liquid and efficient secondary market replenishes and expands the source of capital available for business lending, and reduces the cost of borrowing. The SBA itself has previously recognized the importance of the secondary market in facilitating small business access to capital. As stated in SBA's report to

Congress on its secondary market programs in 1997, "The secondary market plays an important role in enabling lenders to make long-term loans. It provides a market in which these loans can be sold when necessary for liquidity purposes or to match the maturities of assets and liabilities." 2

Notwithstanding the importance of these secondary market activities, and their direct connection to the achievement of SBA's basic mission, the Committee believes that in several areas, significant problems exist in the structure and operation of SBA's lending programs. Given its size and importance, these problems are particularly acute in the case of the 7(a) loan program. 3 As described below, these problems have led to dislocations in the secondary market, resulting in inefficiency, reduced investor confidence and diminished liquidity. Unless these problems are adequately addressed, the Committee is concerned that the long-term viability of the SBA's lending activities may be impaired, to the detriment of secondary market participants, lenders, and most importantly, small business borrowers.

In the Committee's view, the most critical problems in the structure and operation of the SBA's lending programs fall into three main categories: (A) accelerating prepayment behavior involving 7(a) loans and pool certificates (including IO strips), and related deficiencies in the structure and enforcement of SBA contract provisions dealing with prepayments; (B) the lack of adequate performance data on outstanding 7(a) loans; and (C) the lack of suitable structural alternatives to the 7(a) lending program available to borrowers.

SUMMARY OF RECOMMENDATIONS

A more detailed description and discussion of these problems, as well as the Committee's specific recommendations for addressing them, are presented in the remaining sections of this letter. In summary, however, our basic recommendations are as follows:

(1) As the administrator of the 7(a) program, and the party responsible for the structure, content and enforcement of all related lending forms and agreements, SBA should clarify and diligently enforce the terms of its Secondary Participation Guarantee Agreement ("Form 1086"). In particular, pursuant to the explicit terms of the Form 1086, SBA should require that purchasers and holders of 7(a) loans and pool certificates (including IO strip holders) receive a refund of any premium that was paid for a loan that prepays within 90 days or defaults within 275 days of the Warranty Date;

(2) SBA should extend the premium warranty period for 7(a) loans from 90 to 365 days (or such lesser time period as may be compatible with sale accounting treatment);

(3) SBA should consider introducing prepayment penalties on 7(a) loans;

(4) To meet the varied financing needs of small businesses, and promote the appropriate utilization of the current 7(a) lending program for long-term financing, SBA should develop a separate, short-term loan program;

(5)SBA should authorize its exclusive fiscal and transfer agent, Colson Services Corporation ("Colson") to disseminate publicly certain additional data relating to 7(a) loans and lenders, including lender-level, geographic and industry sector performance data; and

(6)To facilitate additional liquidity in the secondary markets for 7(a) loans, and to improve the liquidity and trading efficiency of more seasoned, smaller pools, SBA should authorize the creation of weighted average coupon ("WAC") pools as well as "mega" pools.

DISCUSSION

7(a) Loan Prepayments; Structure and Enforcement of Related SBA Loan Provisions

Members of the Committee are greatly concerned by the alarming increase in 7(a) loan prepayments after their sale in the secondary market. Prepayments are also increasingly common for loans not sold in the secondary market. For example, according to SBA data obtained from Colson, the constant prepayment rate ("CPR") over the life of all variable rate government loan participation certificates as of January 1995 was 8.01%. As of August 1998, the life CPR for such securities had increased to 11.2%. We believe that this rapidly accelerating prepayment profile of 7(a) loans is contrary to the Congressional intent and philosophy of the 7(a) program as a long-term financing vehicle. 4

Some amount of prepayment activity, of course, should be expected in any long-term lending program where partial or full prepayments are permitted at any time, without penalty. However, we believe that the most creditworthy borrowers are typically incented and best able to prepay their 7(a) loans and refinance them as non-guaranteed loans at marginally lower rates. Such refinancings may, in the short-term, constitute a success of the 7(a) program as government-guaranteed borrowers gain access to conventional financing sources. We are concerned on a long-term basis, however, that when prepayments occur relatively early in the lending cycle, scarce 7(a) commitment dollars are not being directed to their intended targets—small businesses that cannot otherwise obtain long-term conventional bank loans. Such widespread, early refinancings of 7(a) loans thereby reduce the amount of higher quality, better credit loans from the SBA's 7(a) loan portfolio, leaving a disproportionately higher ratio of lower credit quality loans subject to the SBA guarantee. This dynamic, together with the reduction in the SBA's 7(a) guaranty subsidy calculation that results from the early retirement of any 7(a) loan, introduces higher default risk and increased financial exposure to SBA.

Moreover, conventional lending sources are frequently unwilling or unable to extend conventional loans to start-up businesses. Accordingly, as discussed below, we believe that those 7(a) program lenders who extend such credit should have access to prepayment

protection, in the form of a prepayment penalty, for accepting such initial commercial lending risk and helping the SBA to achieve its small business assistance policy goals.

Although it may not be possible to prevent prepayments per se, the SBA does not appear effectively to be using policy or enforcement mechanisms at its disposal to encourage the appropriate use of the 7(a) loan program as a source of long term business financing or, at a minimum, to compensate premium purchasers of 7(a) loans, pool certificates or IO strips upon early prepayment.

As noted above, many 7(a) loans purchased at a premium in the secondary market prepay early, often within the existing premium warranty period, whether due to voluntary prepayment or default. The occurrence of this event triggers a contractual obligation on the part of the lender to refund to the purchaser any premium it received in connection with the loan sale. 5 Form 1086 also indicates that the "Lender's failure to refund such premium to Registered Holder may, as determined by SBA, constitute a significant violation of the Rules and Regulations of the Secondary Market." 6 The Form 1086 provisions clearly evince SBA's policy to protect secondary market purchasers of 7(a) loan obligations, by requiring that they be compensated in the event of premium losses occurring shortly after acquisition.

However, Committee members report that this provision is routinely not observed by lenders. More disturbing, Committee members report that SBA has repeatedly disavowed any responsibility for enforcing this provision, or disciplining lenders who fail to observe it. This response has been given despite the fact that SBA administers the 7(a) program, established the policies and contractual provisions outlined above and is a signatory to every Form 1086. We believe that SBA's failure to oversee and enforce compliance with this provision sends an unfortunate and unwarranted signal to lenders and other market participants that their contractual obligations relating to borrower prepayments or defaults under the 7(a) program are not important, and need not be met.

The common occurrence of such prepayments, and the apparent lack of enforceability of the premium warranty provisions set forth in Form 1086, have become increasingly serious problems for all market participants, including the SBA, as the volume of such prepayments and premium losses grow. The incidence of these losses fall upon the registered holder of the related obligation. Such holders and investors lose not only their expected long-term investment return, but also any premium they may have paid in acquiring the instrument. The only recourse available to registered holders is to pursue the return of such premiums directly from lenders. Such efforts entail significant burdens and expenses, especially if pursued through litigation or judicial process. In the end, these burdens and costs translate into diminished investor confidence, and reduced secondary market liquidity and efficiency for 7(a) loans, which are eventually reflected adversely in the availability and terms of credit available to small businesses.

Apart from whether the current premium provision is being enforced, there is also apparently some confusion within the SBA regarding the situations in which it is applicable to begin with. For example, Committee members are aware of situations

involving 7(a) loans that have been pooled, in which refunded premiums were deposited into the SBA's master reserve fund, rather than being returned to the registered holders of the pool certificates (on a pro-rata basis). Holders' claims to the refunded premium were denied by the SBA (apparently, on the basis of an administrative decision) because the pool certificate holders are not parties to the Form 1086, and are therefore not entitled to the premium.

Members of the Committee believe that, regardless of the form in which ownership of a 7(a) loan may be evidenced (i.e., either as a whole loan or as part of a pool or IO certificate), the registered holder or holders of that ownership interest are entitled to the refund of any premium pursuant to the provisions of the related Form 1086. The SBA apparently does not assert that these provisions of Form 1086 no longer apply in the case of loans that have been pooled, but rather that the act of pooling the loan has somehow changed the registered holders' contractual entitlement to the premium—specifically, by conveying this right to the SBA. Members of the Committee would like an explanation and clarification from the SBA of the legal or contractual principles that underlie this determination, as well as the administrative authority under which it may be acting to designate premium refunds on pooled loans for deposit into the master reserve fund.

Recommendations

1. Enforce the Existing Provisions of the Premium Warranty Provisions of Form 1086 and Clarify Their Application

Based upon the foregoing, the Committee urges the SBA actively and diligently to enforce the existing provisions of Form 1086, particularly as they relate to the refund of premiums during the applicable premium warranty period. We also request that the SBA clarify the application of these premium warranty provisions, and the rights of registered holders, in the case of 7(a) loans, pool certificates and IO strips.

2. Extend the Premium Warranty Period from 90 to 365 Days

The Committee also recommends that SBA extend from 90 days to 365 days the warranty period for refunding premiums to registered holders of 7(a) loans, pool certificates and IO strips. In addition to providing such holders with a longer premium recovery period, such an extension would promote the appropriate use of the 7(a) program as a long-term financing vehicle and help to protect premium investors and IO strip holders. In addition, we believe that such an extension of the warranty premium period would provide improved protection from 7(a) loan prepayments, and corresponding impacts on the guaranty subsidy. Most importantly, such an extension would help to ensure that the SBA's 7(a) guaranty authority continues to benefit the small business borrowers, by discouraging prepayments and refinancings soon after these long-term 7(a) loans are originated. We understand, however, that certain accounting issues may need to be

addressed in connection with this recommendation (e.g., whether such an extension would prevent a lender from taking income from a loan sale within one year.)

3. Introduce Prepayment Penalties on 7(a) Loans

Members of the Committee believe that an effort by SBA to devise and impose modest, scaled borrower prepayment penalties on 7(a) loans would also significantly reduce the current incentive for many 7(a) borrowers to refinance their 7(a) loans as non-guaranteed commercial loans at marginally lower rates. For example, such a prepayment penalty provision might be structured as follows: For prepayments greater than 20% of the outstanding principal balance of any 7(a) loan, a prepayment penalty of (1) 5% of the outstanding balance of the loan the first year, down 1% each successive year to 1% of the outstanding balance the fifth year, for loans having original terms greater than or equal to 15 years, or (2) 3% of the outstanding balance the first year, down to 1% the third year, for loans having original terms less than 15 years. Such a modest penalty would encourage borrowers whose actual financing needs are in fact of a short-term nature not to misuse the SBA's long-term lending guarantee for their short-term or bridge financing needs, and help ensure that the small business borrowers who seek long-term financing under the 7(a) program intend to use 7(a) loans for long-term purposes. Also, there are traditionally other market benefits associated with the origination, sale and trading of loans with prepayment penalties. Borrowers are generally able to obtain cheaper financing for such loans. In addition, government-guaranteed loan traders have informed us that they typically pay higher prices for U.S. Department of Agriculture loans with prepayment penalties than for those without such penalties, which improves their secondary market execution.

Recommendations to Expand Disclosure of Lender Performance Data

We encourage SBA to facilitate the expansion of the categories of 7(a) lending data made available by Colson, such as specific lender, geographic and industry sector performance. Such additional data would permit SBA secondary market participants to review, for example, prepayment information at the lender level, and to determine whether SBA loan prepayments are concentrated by geographic area, specific lender, type of industry, or other factors. Such information is extremely valuable to secondary market traders and investors who buy, sell and trade such loans. It permits them to differentiate bids based on disclosed trends and conduct prudent due diligence to determine a security's value based on geography, lender prepayment history or industry trends. We believe that the increased investor confidence resulting from access to this data will contribute to greater overall liquidity for 7(a) loans in the secondary market. Accordingly, we request that SBA take any steps necessary to make publicly available more detailed 7(a) loan information.

Presently the only 7(a) pool data that are available to secondary market participants are loan amount, rate and maturity. In addition, the 7(a) prepayment data currently available do not make a distinction between defaults and refinancings, and should do so. This lack of data on 7(a) loans, pool certificates and IO strips contributes significantly to

inefficiencies in the analysis, pricing and trading of 7(a) products. Moreover, the availability of such scant data stands in stark contrast to the wealth of data that are currently made available to dealers and investors of mortgage-backed securities (MBS) by federal housing agencies such as Fannie Mae, Freddie Mac and Ginnie Mae. As SBA is aware, other federal agencies with guaranteed lending programs have produced and routinely permitted the release of such loan data for years. Such information is routinely used and valued by secondary mortgage market participants, and has arguably contributed to the significant increase in the volume and efficiency of MBS trading. For example, in addition to making pool amount, rate and pool maturity information available, Freddie Mac provides data via its website which allows the extraction of historical information on loan paydown factors, original and current WAC, weighted average remaining maturity ("WARM"), weighted average loan age ("WALA"), loan origination year, and pool factor quartiles. In addition, for pools that are originated by one lender, Freddie Mac makes available monthly factors for such pools by lender. Such data permit traders and investors efficiently to review any prepayment trends associated with a specific lender, and make investment decisions accordingly. We believe that open access to such MBS pool information plays an important role in promoting the high level of investor confidence, liquidity and efficient pricing of federal housing agency securities. The Association also believes that SBA should make available such additional data on SBA 7(a) loans in order to promote prudent investment decisions in a fair and orderly market.

It is our understanding that Colson would need explicit authorization from the SBA in order to commence disclosing loan/lender performance data regarding defaults, prepayments and other information broken down by lender. Because there is not currently a sufficient data source, we urge the SBA to provide such authorization to Colson.

Recommendations for Structural Alternatives to the 7(a) Program

1. Develop an Alternative, Short-Term Financing Program

Members of the Committee encourage SBA to create another, alternative short-term lending program which might reduce the need and/or opportunity for borrowers to refinance long-term SBA loans under the current 7(a) program. We believe that the rise in 7(a) loan refinancing activity should serve as evidence that there exists a need for small business short-term/bridge financing. The addition of such an alternative program would help to resolve current conflicts regarding the structure and purpose of the current 7(a) lending program.

The Association recommends that the SBA develop a variable-term lending program, for example, a 3-year fixed-rate loan product which prohibits prepayments, with an option to roll such loans into a 25-year term loan at the end of three years. Such a product would provide small business borrowers with short-term financing, with the flexibility of longer loan terms, as desired. In this regard, the Association also recommends that SBA revise the maximum rate structure on fixed-rate loans, which is currently at 11.25%, and should

index such loans to a long-term (i.e., 10-year) Treasury index, as opposed to the short-term prime index currently used.

Permit Creation of Weighted Average Coupon ("WAC") Based Pools and Mega Pools

To facilitate improvements to SBA 7(a) loan liquidity and trading in the secondary markets, we encourage SBA to facilitate the introduction of WAC-based pools to supersede the current practice of assigning a coupon to a certificate based upon the lowest interest rate borne by any loan in a group. For example, we suggest developing a market convention based upon a 75 basis point differential spread as the variance of interest rates on individual 7(a) loans that may be pooled together. The creation of WAC pools would not only help the secondary market, but SBA borrowers and lenders as well. WAC pools would allow lenders to offer lower spreads above the prime rate and not suffer severe back bids because a pooler could not buy enough odd coupon loans to create a pool. Easier pooling would also reduce secondary market buyers' demand for pricing concessions for single SBA odd-coupon loans. WAC 7(a) pools would also benefit small business borrowers by allowing lenders to more easily offer reduced interest rates to borrowers without making concessions when selling such odd coupon loans in the secondary market.

In addition, because many seasoned SBA loan pools now have relatively small balances outstanding, the Committee urges the SBA to permit the pooling of these small outstanding pool balances into "mega" pools. Such additional pooling flexibility would improve the liquidity and trading of such older, smaller SBA pools. The federal housing agencies have for several years successfully used such programs to pool together and sell their own smaller mortgage pools. The creation of such "mega" pools would also greatly enhance the bids for "odd-lot" secondary pools consisting of relatively few loans, making 7(a) loans a more consistently attractive investment.

CONCLUSION

Based upon the foregoing, the Committee urges the SBA to take appropriate steps in order to (1) improve enforcement of Form 1086, (2) expand the premium warranty period from 90 to 365 days, (3) introduce prepayment penalties on 7(a) loans; (4) improve data disclosure, (5) develop an alternative short-term financing program and (6) permit the creation of WAC-based and "mega" SBA pools.

We thank you for your consideration of the above matters. If you have questions or would like additional information concerning any of the foregoing, please contact the undersigned at 212.778.2741, or Eileen McCarthy Neiman, Staff Advisor to the Government Business Loan Committee of the Association, at 212.440.9458.

Sincerely,

DONNA FAULK

Vice President, Mortgage-Backed Securities, Prudential Securities, Inc.

Chairman, Government Business Loan Committee of The Bond Market Association

cc: Aida Alvarez, Administrator,
Small Business Administration
James Hammersly, Director of Secondary Market Sales,
Small Business Administration
William B. Shear, Assistant Director, Financial Institutions and Market Issues,
U.S. General Accounting Office
Anthony Wilkinson, President,
National Association of Government Guaranteed Lenders
Members of the Government Business Loan Committee of The Bond Market Association
Paul Saltzman, George Miller, Michael Decker, Eileen Neiman,
The Bond Market Association

FOOTNOTES

1 The Bond Market Association represents securities firms and banks that underwrite, distribute and trade fixed-income securities, both domestically and internationally. Additional information regarding the Association, its members and activities can be obtained from our website (www.bondmarkets.com).

2 SBA Secondary Market Program for Calendar Year 1997-13th Annual Report to the Senate and House of Representatives.

3 The Administration's Budget for 1999 includes a record \$15.3 billion in SBA loan guarantees-over \$11 billion of which would be directed to the 7(a) program.

4 The SBA itself acknowledges the role and importance of this long-term lending function. The SBA's 1997 Report to Congress, for example, indicates on page 6 that, "One of the major benefits of the SBA guaranteed loan program is that it provides small businesses with access to long term loans. Banks are normally not long term lenders."

5 Section II, Item 3 of Form 1086 provides as follows: "If a borrower prepays the loan for any reason within 90 days of the Warranty Date, Lender must refund any premium received. If the borrower fails to make the first three monthly payments due after the Warranty Date and the borrower enters uncured default within 275 days from the Warranty Date, Lender shall refund any premium received."

6 Despite the appearance of this provision in Form 1086, and its suggestion of a body of rules and regulations governing secondary market activities involving SBA guaranteed obligations, members of the Committee are not familiar with any specific compilation of "Rules and Regulations of the Secondary Market." We respectfully request the SBA's more specific identification of the nature, content and applicability of this source of contractual duties and obligations.

