Board of Governors of the Federal Reserve System
U.S. Securities and Exchange Commission

Report to the Congress on Markets for Small-Business- and Commercial-Mortgage-Related Securities

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September 2000

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Submitted to the Congress pursuant to section 209 of the Riegle Community Development and Regulatory Improvement Act of 1994

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Contents

Page

I. Executive Summary and Introduction 1
A. Securitization Activity and Credit Availability 2
B. Recommendations 4

II. The Market for Securitized Commercial Mortgages 5
A. Recent Market Developments 5
B. Characteristics of Commercial-Mortgage-Backed Securities 7

III. The Market for Securitized Small-Business Loans 9
A. Recent Market Developments 9
B. Characteristics of Small-Business-Loan Securitizations 10

IV. Regulatory and Structural Changes since the 1998 Report 14
A. Trust Entities for Securitization 14
B. FASB Statement No. 125 and Receivership Powers of the FDIC 15
C. Revision of Risk-Based Capital Rules 16
D. Recent SBA Regulatory Changes 16

Exhibits
1. Direct Holdings of Commercial Mortgage Loans, by Major Holder 18
2. Commercial Mortgage Debt Outstanding 19
3. Commercial Mortgage Interest Rates and Loan Delinquency Rates 20
4. CMBS Spreads and Yields 21
5. Net Flows of Commercial Real Estate Debt and Equity Financing, by Source 22
6. Total Outstanding Commercial Real Estate Debt and Equity Financing, by Source . . . 23
7. Gross Issuance of CMBS, by Property Type and Rating Class 24
8. Gross Issuance of CMBS, by Credit-Rating Firm and Type of Offering, Loan Origination, and Seller/Borrower 25
9. Growth of Small-Business Loans at U.S. Commercial Banks 26
10. Characteristics of Securities Backed by Small-Business Loans 27
11. Small-Business-Loan-Backed Securitizations, by Seller 28
12. Small-Business Loans Transferred with Recourse by Commercial Banks 29
13. Small Business Administration 7(a) Loans 30

Appendixes
A. Section 209 of the Riegle Community Development and Regulatory 31
Improvement Act of 1994
B. Risk-Based Capital Requirements 32

I. Executive Summary and Introduction

Section 209 of the Riegle Community Development and Regulatory Improvement Act of 1994 (the Riegle Act) requires the Board of Governors of the Federal Reserve System and the Securities and Exchange Commission (the agencies) to submit a joint study by September 23 of 1996, 1998, and 2000 addressing the effect of that legislation on

- the structure and operation of the markets for securitized small-business loans and commercial mortgages; and
- the availability of credit for business enterprises.

The Riegle Act also requires the agencies to consider recommendations for further legislative or administrative action.[1] This is the third and final report submitted in accordance with these requirements.

Like the Secondary Mortgage Market Enhancement Act of 1984 (SMMEA), which removed regulatory obstacles to the securitization of residential mortgages, the Riegle Act was designed primarily to remove legal impediments to the development of markets for securities related to small-business loans and commercial mortgages.[2] The Riegle Act extended regulatory accommodations similar to those available under SMMEA. These reforms included

- amendments to the federal banking laws to allow national banks, federal savings and loan associations, savings banks, and credit unions to invest more easily in these securities;
- preemption of state registration requirements and investment restrictions; and
- modifications to the federal securities laws to accommodate settlement and delivery practices.

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[1] Specifically, section 209 requires the agencies to address the effect of subtitle A of title II, dealing with the securitization of small-business-related loans, and sections 347 and 350 of title III, dealing with the securitization of commercial mortgages (see Appendix A).

[2] See S. Rep. No. 103-169, 103rd Cong., 2nd Sess. 30-38 (1994); H.R. Conf. Rep. No. 103-438, 103rd Cong., 2nd Sess. 166-1967 (1994). Section 202 defines a "small business concern" as "a business that meets the criteria for a small business concern established by the Small Business Administration under section 3(a) of the Small Business Act."

The Riegle Act also made participation of depository institutions in small-business-loan securitizations easier by instructing federal bank regulators to reduce risk-based capital requirements.

The first report to the Congress, submitted in 1996 (the 1996 Report), provided a fairly extensive review of activity in the markets for securitization, the unique features of small-business and commercial real estate loans, and the legal changes effected by the Riegle Act.[3] The second report (the 1998 Report) focused on changes that took place in the markets between 1996 and 1998. This third report focuses on subsequent developments. Specifically, section I provides an overview of securitization activity and credit availability in the interim two years and presents the agencies' views on the need for further administrative or legislative initiatives. Sections II and III provide details on the volumes and types of securitizations of commercial real estate and small-business loans to date. Section IV updates information on previously cited securitization impediments and recent regulatory changes.

A. Securitization Activity and Credit Availability

Demands for credit to finance small-business and commercial real estate activity have remained robust since the 1998 Report. Total commercial mortgage debt and small-business loans expanded briskly in 1998 and 1999 despite some overall firming of credit market conditions. Available information for the first half of this year implies that the pace of borrowing has remained brisk, although it has begun to show signs of slowing in recent months.

At the same time, securitization of commercial mortgage loans, which had been expanding at a double-digit pace, has slackened markedly since mid-1998, when financial markets globally were rocked by the turbulence that followed the Russian default. Although financial markets have recovered since then, interest rates on riskier or less liquid private-sector debt, including commercial-mortgage-backed securities (CMBS), contain larger premiums than before. Yields on the underlying mortgages also have risen but less than those on CMBS. The lower spreads between rates on the underlying mortgages and those on the securitized instrument have reduced the perceived profitability of securitizing commercial mortgages. As a result, the

[3] The first report has a detailed discussion of the Riegle Act's provisions that were intended to remove regulatory obstacles to the securitization of loans to small businesses and mortgages on commercial real estate.

net flow of domestic CMBS, which totaled $61 billion in 1998, fell to about $40 billion in 1999 and is on track to come in lower this year. Meanwhile, borrowers in commercial real estate markets have increasingly tapped banks and life insurance companies as the financing sources of choice over the past couple of years.

Securitization of small-business loans generally has proceeded at a much slower pace than that of commercial mortgages and to date cannot be considered a significant source of credit to small businesses. Still, the volume of small-business-loan securitizations nearly doubled in both 1998 and 1999 as a few large banks joined The Money Store, AMRESCO, and other nonbank securitizers in this area. The growing bank involvement may result in part from the relaxation of Small Business Administration (SBA) regulations that previously prohibited banks from securitizing the non-guaranteed part of SBA 7(a) loans. As these banks have become more comfortable with the process, they have securitized an increasing volume of conventional (non-SBA) loans as well as 7(a) loans. Most banks, however, have not shown much interest in selling or securitizing small-business loans on their books. For some, the margins are too thin to make these transactions profitable, while others may prefer to bolster the size of their assets by retaining the loans.

The pool of nonbank financial firms that engage in small-business securitizations has been changing, due largely to mergers and acquisitions. For example, Fremont Financial was a major securitizer before its acquisition by FINOVA in 1999, but it has since dropped out of this market. Similarly, The Money Store was recently acquired by First Union and is discontinuing its small-business-loan securitizations. The Money Store--now called First Union Small Business Capital--has completed no new deals in this market in 2000. Several small issuers who have been acquired by larger financial institutions also appear to have dropped out of the small-business securitization market. For some, access to a wider range of funding sources through mergers has lessened the importance of the securitization of small loans. In addition, a few of the acquirers are companies that have Preferred Lender Program (PLP) status with the SBA. Some of these lenders have expressed concern about a 1999 SBA ruling that requires a quarterly review of their loan portfolios if they engage in securitizing the nonguaranteed portion

of SBA 7(a) loans.[4] An important new issuer is AMRESCO, which began operating in the small-business finance area in 1997 and has since completed about seven securitizations totaling more than a billion dollars.

Thus far in 2000, the volume of securitizations of small-business loans, like other types of securitizations, has fallen and totals for the year are unlikely to match those of 1998 or 1999. Much of this pullback is cyclical, reflecting rising investor caution and less hospitable markets for assets viewed as risky and illiquid. Over time, however, the agencies expect the trend toward increasing securitization to continue as banks and other lenders become more familiar with the process and as methods for evaluating the riskiness of small-business loans to be pooled become less costly.

B. Recommendations

The agencies have not uncovered any major impediments to securitization of commercial real estate or small-business loans that require additional legislative or administrative actions. As discussed in section IV of this report, several regulatory issues cited in earlier reports have been resolved or are progressing toward resolution. One concern that has arisen since the last report involves the 1999 SBA rule change, noted above. The SBA is aware of these concerns but does not believe that they are widespread or that they will prove a serious impediment to securitization of small-business loans generally.

The agencies also believe that current efforts to collect data are adequate for following developments in these markets. Currently, information gathered from depository institutions on their Call Reports, from the credit-rating agencies, from the SBA, and from private-sector reports provides fairly complete coverage of issuance volume. Conversations with securitizers and other market participants will continue to be the best way to identify potential impediments to securitization.

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[4] See section IV.D for a more complete description of the SBA rule.

II. The Market for Securitized Commercial Mortgages

Over the past two years, the market for CMBS has been subject to the various disruptions that have afflicted financial markets generally. The market tumult during the fall of 1998 caused several key participants to exit the market and caused credit-risk spreads to widen substantially, especially for non-investment-grade CMBS tranches. As a result, the growth of commercial mortgages in securitized mortgage pools has slackened, and the growth of loans on the books of traditional portfolio lenders--banks, thrifts, and insurance companies--has accelerated. Banks, in particular, have reported somewhat stronger demand for commercial real estate loans this year, at a time when they have tightened standards a bit for approving these loans. Other markets for securitized debt--including those for residential mortgages, home equity loans, and consumer loans--also have weakened of late, as have markets for below-investment-grade corporate bonds.

Despite the recent sluggish pace of issuance, CMBS remain an important source of financing. Most recently, CMBS have been the source of funding for 11 percent of multifamily mortgage debt and 15 percent of retail, office and other mortgage debt (exhibit 1). At the end of the first quarter of 2000, the outstanding volume of CMBS issued by domestic sellers other than government-sponsored enterprises (GSEs) stood at $205 billion, with another $59 billion of multifamily mortgage debt securitized by GSEs (exhibit 6).

A. Recent Market Developments

Primary Market for Commercial Mortgages. Demands for credit to finance commercial real estate activity have remained robust since the 1998 Report. Total commercial mortgage debt outstanding increased to more than $1.5 trillion by the first quarter of 2000, up from less than $1.3 trillion at the end of 1998, despite some overall firming of credit market conditions (exhibit 2). Growth in retail, office, and other mortgage loans outstanding, which account for three-fourths of total commercial mortgage loans, was particularly robust. Available information for the first half of this year suggests that the pace of borrowing has remained brisk, though it has begun to show signs of slowing in recent months.

Continued high levels of investment in office and other commercial buildings have buoyed commercial mortgage borrowing over this period. Real expenditures on office space, spurred by low vacancy rates and rising prices, moved up sharply through 1998 to the highest levels since the peak of the 1980s building boom. Outlays have remained substantial thus far this year.

Commercial mortgage credit quality has remained very favorable. Delinquency rates on commercial mortgages at commercial banks, at life insurance companies, and in securitized pools are below 2 percent and have been stable for the past two years (exhibit 3).

The 1998 Market Disruption and the CMBS Market. In August 1998, Russia defaulted on some of its sovereign debt and allowed its currency to depreciate, resulting in large losses for investors in foreign exchange markets. The default set off a chain reaction in the credit markets, leading credit-risk spreads to widen throughout the financial markets. The effect of this event on the CMBS market can be seen in the sharp increase in the spreads between the yields on CMBS and the ten-year Treasury bond between August and October 1998 (exhibit 4). Subsequently, yield spreads came down a bit but did not entirely retrace their earlier runup. Yields on BBB-rated CMBS currently exceed those on comparable maturity Treasury issues by nearly 250 basis points, appreciably above the 175 basis-point spread in early 1998.

Several large Wall Street conduits that pool commercial mortgages and issue securities suffered large losses during this period. The increase in CMBS yields lowered the value of the loans they had originated and pooled but had not yet securitized. Moreover, the hedge that they used to protect themselves against the interest rate risk on these loans actually added to their losses rather than cushioned them. To protect against interest rate changes between the time mortgages were originated and the time a pool of mortgages was securitized, conduits shorted U.S. Treasuries. If yields on both Treasury bonds and CMBS rose (or fell) equal amounts, a conduit's short Treasury position would increase (or decrease) in value and offset the decrease (or increase) in the value of the mortgage pool. In the wake of the Russian default, however, Treasury yields fell while CMBS yields increased, causing both the value of a conduit's stockpile of mortgages and a conduit's hedge position to decline in value. After suffering large losses, several prominent Wall Street conduits left the CMBS business.

The market for below-investment-grade CMBS was particularly hard hit by the market disruptions. Only a limited number of firms purchase below-investment-grade CMBS. After yields on these bonds increased, the largest purchaser of below-investment-grade CMBS, Criimi Mae, filed for bankruptcy, and other key players left the market.[5] The increased risk spreads and yields have attracted new investors, and market activity has resumed, but investors may continue to require higher premiums than prevailed in early 1998.

Although the CMBS market has rebounded from the market turmoil of 1998, CMBS have provided a lower share of the net flow of mortgage debt. In 1999, CMBS provided the funding for about 25 percent of the net new multifamily and retail, office, and other mortgage debt, compared with about 50 percent in 1998 (exhibits 5 and 6). In the first half of 2000, CMBS issuance has fallen below the pace of last year. Banks accelerated their net lending after the financial crisis, and life insurance companies and thrifts picked up lending after reducing their commercial mortgage holdings for most of the 1990s.

B. Characteristics of Commercial-Mortgage-Backed Securities

Property Types. Over the past two years, the relative share of properties backing new issues of CMBS was unchanged for retail, increased for office, and declined for multifamily and all other types (exhibit 7). Through mid-year 2000, these relative shares were about 30 percent each for retail and office, 15 percent for multifamily, and 25 percent for all other types.

Ratings and Underwriting Standards. Most home mortgages permit borrowers to prepay at any time without penalty, but most commercial mortgages are written to include one or more prepayment penalties. Therefore, unlike securities backed by residential mortgages, CMBS generally provide some protection from unscheduled prepayments. Although prepayment risk is thus smaller, credit risk typically is greater. When guarantees are not involved, the greater credit risk is due to a general belief that pools of commercial mortgages exhibit greater expected losses than do pools of single-family mortgage loans.

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[5] Criimi Mae recently completed the final asset sale required for its reorganization and hopes to emerge from Chapter 11 bankruptcy in the near future.

The most common method of dealing with the credit risk is to create multiclass securities with junior, or subordinate, components. The junior securities have a right to principal payments only after the senior securities are paid in full. Because the junior securities absorb the first losses in the pool, up to their principal amount, they provide credit protection to the senior classes. The largest shares of securities are senior, and these usually receive a triple-A rating. The junior securities receive lower ratings. Four major agencies rate these securities, with Moody's rating the largest market share (exhibit 8).[6]

Very little information is available on underwriting standards. Moody's Investors Service, however, has analyzed conduit deals that it rates and has seen a marked improvement in the quality of loans in conduits since late 1998.

Average Deal Sizes. After having reached $918 million in 1998, the average deal size for domestic CMBS fell to $615 million in 1999 and to $530 million in the first half of 2000. The decline is due in large part to issuers wanting to limit their interest rate risk by issuing CMBS more frequently, rather than stockpiling loans for larger issues. As a result, large loans--loans of more than $50 million to a single borrower--have been more frequently securitized in stand-alone deals instead of pooled with other large loans or pooled with smaller conduit loans in so-called "fusion" deals. Large loan and fusion deals represented 41 percent of the dollar volume of domestic issuance in 1998 but only 13 percent of the dollar volume in 1999 and 9 percent in the first half of 2000. Single-borrower deals increased from 3 percent of the dollar volume in 1998 to around 12 percent in 1999 and the first half of 2000.

Pricing. Rates on commercial mortgages have risen appreciably over the past two years (exhibit 3). Rates remained stable in the second half of 1998, even as Treasury yields dropped, leading to increased spreads between commercial mortgage rates and Treasury securities. Since then, spreads have remained elevated as mortgage rates have increased about in line with Treasury rates. Issuers of securitized debt have also experienced a large increase in their cost of funds, with the largest cost increases on lower-rated tranches.

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[6] Prior to 2000, Moody's, Standard & Poor's, Duff & Phelps, and Fitch were the four major rating agencies. Subsequently, Fitch and Duff and Phelps have merged. Most CMBS are rated by two rating agencies.

III. The Market for Securitized Small-Business Loans

The potential size of the market for securitized small-business loans appears large when gauged by the amount of small-business loans outstanding at all financial institutions. On June 30, 2000, commercial banks held roughly $405 billion in loans to businesses that originally were in amounts of less than $1 million per loan. The volume of these loans has expanded about 8 percent per year, on average, since 1994 (exhibit 9). Data from the 1993 National Survey of Small Business Finance suggest that banks hold about 60 percent of the volume of small-business credit. Taken together, these statistics imply that about $675 billion of small-business loans are outstanding. Clearly, not all of these loans could be securitized, but even part could provide the basis for a sizable market. Indeed, there has been notable growth in the securitization of small-business loans since the early 1990s. In 1999, more than $2 billion-worth of small-business loans were securitized. But the markets still have a long way to go before these securitizations become a significant share of small-business lending. One factor restraining the development of this market has been banks' preference, in the current financial environment, to hold loans on their own books rather than to sell them.

A. Recent Market Developments

Data available through the first half of 2000 indicate that 64 rated issues totaling about $6.4 billion of securitized small-business loans have been offered either publicly or privately since these securities were first issued in 1992 (exhibit 10).[7] The pace of securitization picked up over the 1990s but has fallen back more recently. After averaging just under $500 million annually from 1992 to 1997, small-business-loan securitizations jumped to $1.2 billion in 1998 and $2.3 billion in 1999. Issuance dropped off in the first half of 2000.

A few finance companies have played a dominant role in the market for securitizations of small-business loans since 1998 (exhibit 11). These companies have originated large pools of loans and have experience in securitization. The Money Store--now called First Union

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[7] These sixty-four issues likely account for most of the market because almost all placements are evaluated by a rating agency. Nonetheless, some placements may have been missed. These data do not include securitizations of loans guaranteed under SBA loan programs.

Small Business Capital--had been the largest issuer until this year and the only issuer to sell in the public bond markets in the past two years. Its twelve issues from 1992 through 1999 accounted for more than one-quarter of total issuance over the period, however, it has not issued any small-business-backed securities in 2000, and First Union is ceasing these operations.

Despite the easing of capital requirements on qualified small-business-loan securitizations, only a few commercial banks have engaged in this type of activity. Banks are required to report the number and volume of loans sold with recourse that qualify for the special capital treatment prescribed in the Riegle Act.[8] As shown in exhibit 12, these amounts to date have been small, especially when compared with the volume of small-business loans held on the books of banks. Several banks, however, began to securitize the nonguaranteed portion of SBA 7(a) loans after the SBA relaxed its prohibitions on bank participation in 1997 and have branched out into non-SBA loans. In particular, five banks--Zions First, Sierra West, First Source Corp., First International Bank, and Bank of Yorba Linda--accounted for about one-third of total small-business-loan securitizations during the two-year period 1998 to 1999 (exhibit 11).

B. Characteristics of Small-Business-Loan Securitizations

SBA 7(a) Loans. The 7(a) Loan Guaranty Program is one of the SBA's primary lending programs. For applicants that meet the SBA's credit standards, the agency will guarantee up to 80 percent of loans less than $100,000 and 75 percent of loans greater than $100,000, with a maximum guarantee of $750,000. Securitization of the *guaranteed* portions of SBA 7(a) loans has been sizable for a number of years. About 40 percent of the guaranteed portions have been securitized since 1994. In contrast, only about 10 percent of the *nonguaranteed* portions have been securitized (exhibit 13).

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[8] When a bank sells loans with recourse, it assumes a first-loss position on some portion of the group of loans that were sold, enhancing the attractiveness of the pool to investors. Most securitizations, or sales of a security whose return depends on the performance of an underlying pool of loans, involve at least some credit enhancement through recourse.

Nonetheless, issues backed by the nonguaranteed portion of SBA loans have accounted for a sizable share of total small-business-loan securitizations (excluding guaranteed loans) in the 1990s. Almost all securitizations of the nonguaranteed part of SBA loans involve loans that are backed by real estate, and some carry additional types of security, such as liens on equipment, claims on accounts receivable, and personal guarantees. The average maturity of the SBA loans in the pool is fairly long: Fifteen to twenty years is typical. Interest rates on the loans can be fixed or floating but are typically indexed to the prime rate.

The SBA implemented an interim rule change in 1997 that, among other things, allowed banks to securitize the nonguaranteed portion of SBA loans. Only nonbanks could do so previously.[9] Since then, as noted above, a handful of large banks has begun to securitize the nonguaranteed portions.

The final rule (13 C.F.R. pt. 120.425), which became effective in April 1999, also provides an incentive for securitizers to continue to follow sound underwriting standards in making small-business loans by threatening to remove PLP status. PLP status is valued because it allows a lender to approve and fund a loan without the SBA's involvement. The PLP status is reviewed only biennially for those that do not securitize. Lenders that securitize the nonguaranteed 7(a) portion of SBA loans are subject to a quarterly test of loan quality. If the lender's loan quality has fallen below its initial quality rating or has fallen relative to the overall loan quality of the entire SBA 7(a) guaranteed loan portfolio, the lender may lose PLP status, a prospect that might deter some lenders from participating in securitizations.[10]

SBA loans are likely to continue to be securitized, but because the 7(a) loan program is constrained by the SBA's budget, these securitizations will not be the basis for future rapid growth in small-business-loan securitizations. This suggests that if the market for securities backed by small-business loans is to continue to expand, it will most likely do so through securitizations of non-SBA or *conventional* loans.

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[9] See "Rules and Regulations," Federal Register, vol. 62, no.63 (April 2, 1997), p.15601.

[10] See section IV.D for additional detail on this rule.

Conventional Loans. The number of securitizations of conventional small-business loans (that is, those not made under the SBA 7(a) program) has been increasing. The growth in issues backed by conventional business loans accounts for the bulk of the increase in total securitizations over the past couple of years (Exhibit 10). Conventional loans have collateral that is similar to that of the SBA loans, but they do not have the SBA guarantee. The average maturity of the loans in a non-SBA 7(a) pool is typically only five to twelve years. Interest rates on these loans can be fixed or floating, with floating rates typically indexed to LIBOR or prime.

The 1996 and 1998 Reports noted several natural impediments to securitization of conventional small-business loans, especially the lack of standardized lending terms and uniform underwriting guidelines for these loans, which makes rating a pool of loans difficult. In the past few years, the pool of small-business loans that can be readily securitized seems to have grown. In particular, the increasing use of credit-scoring models among the largest lenders is generating a substantial portfolio of small-business loans, all of which have been rated using similar scoring systems.[11] Still, securitizations remain small relative to the pool of outstanding small-business loans.

A few private-sector groups have attempted to pool loans from smaller commercial banks lacking sufficient loan volumes to develop cost-effective securitization programs on their own. About a third of commercial bank loans to small businesses were held by institutions with total assets of less than $500 million. Thus, there is plenty of volume for securitizations when loans are pooled across these small and mid-sized banks. However, a number of factors have hindered the success of these initiatives. Although credit scoring is becoming more universal, considerable heterogeneity remains in evaluating loans across banks. Also, smaller banks may offer interest rates that do not provide a margin big enough for securitization to be profitable. Some institutional factors may make smaller banks reluctant to sell loans to securitizers. For example, small banks often emphasize their provision of long-term customer relations, which may erode if the bank sells loans it originates. Finally,

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[11] One system for scoring small-business loans, developed by Fair-Isaacs, has been purchased by more than 300 large lenders. Although some of these banks have customized their scoring systems to their particular small-business markets, this system has imposed some degree of comparability of the scores across lenders. A 1998 study by Robert Morris Associates indicated that the vast majority of banks that use a credit-scoring model use the Fair-Isaacs system.

managers at smaller banks may be evaluated, at least in part, on total assets on the balance sheet, which would give them an incentive to keep loans on the bank's own books.

Community Development Loans. Although many community development loans finance affordable multifamily housing, some fund small businesses in low- and moderate-income areas. Several nonprofit organizations have arranged warehousing systems that allow them to purchase and pool community development loans. The securitization of community development loans has been limited because of the concessionary rates that often are offered on these loans and the difficulty of evaluating risks of these loans. The Community Reinvestment Fund (CRF) is the most active securitizer of community development loans. Since its founding in 1988, the CRF has securitized more than $130 million of community development loans; roughly half are small- business loans. While still small relative to the pool of available loans, CRF's annual purchase of loans has more than doubled since the 1998 Report. Because of the nature of their nonprofit charters, pool participants are not allowed to purchase loans from a lender unless that lender agrees to channel all of the proceeds of the loan sale back into new development loans. As a result, most of the volume of securitizations of community development loans has come from state and local development corporations and small-business-investment corporations.

IV. Regulatory and Structural Changes since the 1998 Report

The 1998 Report discussed four regulatory issues that a number of market participants had cited as continuing impediments to the securitization process. Those issues included

- the limitation on investments in small-business- and commercial-mortgage-related securities by employee benefit plans;
- proposals by the Comptroller of the Currency to limit bank investments in commercial-mortgage-related securities;
- the need for a more efficient trust entity for securitizing nonresidential mortgage assets; and
- the interpretation of Financial Accounting Standards Board (FASB) Statement No. 125 with regard to asset "sales" by banks when the Federal Deposit Insurance Corporation (FDIC), acting as a receiver for a failed U.S. bank, has authority to reclaim transferred assets.

At the time of the last report, legislative and regulatory actions had helped to alleviate the problems associated with the first two issues; however, the latter two issues were still open. These issues, as well as two new regulatory developments--the reduction of capital charges on highly rated asset-backed securities and an SBA ruling applicable to lenders who securitize nonguaranteed portions of 7(a) loans--are discussed below.

A. Trust Entities for Securitization

The 1998 Report noted that the Congress responded to market participants' desire for a more efficient trust entity for securitizing nonresidential mortgage assets by authorizing a new tax vehicle called a Financial Asset Securitization Investment Trust, or FASIT. The FASIT statutory provisions were made effective as of September 1, 1997, and the Treasury issued proposed regulations in February 2000, but until such regulations are finalized, the resulting uncertainty will likely continue to hinder the growth of FASITs. These regulations will probably not become final this year. Meanwhile, market participants have found other vehicles of choice that seem to have reduced the immediate interest in FASITs.

B. FASB Statement No. 125 and Receivership Powers of the FDIC

For the transfer of a loan or other financial asset to qualify as a sale, FASB 125 requires that the transferred loan be "isolated from the transferor--put presumptively beyond the reach of the transferor and its creditors, even in bankruptcy or other receivership." Some confusion, however, has arisen about the treatment of loans transferred by a U.S. bank that subsequently fails and is placed in receivership by the FDIC. When it first looked at this question, the FASB understood that the FDIC might reclaim a loan asset but only if it repaid the principal and interest earned to the date of payment to the investor--in essence making the investor whole. Under these conditions, the FASB concluded that the FDIC powers did not preclude a bank loan from being treated as a sale under FASB 125.

The FASB staff in late 1997 learned that the FDIC's powers are somewhat broader and do not require full payment of interest earned to the date of payment. Rather, the FDIC is required to pay interest earned only to the date of receivership, which may fall short of the date of payment by as much as 180 days. In that event, the investors might not be made whole.[12] The FASB proposed revising the language in FASB 125 to state: "The ability of a receiver to reclaim transferred assets by paying anything less than principal and interest to date of payment (for example, principal and interest to date of receivership) would preclude sale accounting." This approach could preclude sale accounting for many transfers as currently structured by financial institutions subject to FDIC oversight.

In December 1998, the FDIC issued a proposed Statement of Policy that was intended to reassure interested parties (such as the FASB and market participants) that subject to certain conditions, such as fraud, the FDIC, as conservator or receiver, would not seek to reclaim, recover, or recharacterize securitized financial assets if the sponsoring bank went into conservatorship or receivership. The proposed Statement of Policy was withdrawn in September 1999 because market participants wanted even greater assurance that the FDIC would not seek to recover securitized assets. As a result, the FDIC issued a proposed rule in October 1999 to address this issue. This rule, which took effect September 11, 2000, states that the FDIC will not use its power to repudiate contracts or recover assets that were sold by a bank or thrift in

[12] In fact, the FDIC most often pays interest earned to date of payment unless the assets have been conveyed in a fraudulent manner or to an affiliate under improper circumstances.

connection with a securitization or participation, provided that the transfer meets all the conditions for sale treatment under generally accepted accounting principles, that the transfer is made for adequate consideration, and that other specified conditions are met.[13]

C. Revision of Risk-Based Capital Rules

In March 2000, the U.S. banking agencies issued a proposed rule on securitization that would reduce the capital charge on highly rated asset-backed securities (ABS), including CMBS and securities backed by SBA loans. Under this proposal, "the agencies would use credit ratings and certain alternative approaches to match the risk-based capital requirement more closely to a banking organization's relative risk of loss in asset securitizations."[14] The market expects this change in risk-based capital rules to encourage investment in high-quality ABS and CMBS.

D. Recent SBA Regulatory Changes

Since the 1998 Report, the SBA issued its final rule (13 C.F.R. pt. 120.425) on the minimum elements that the SBA will require before consenting to a securitization. Under this rule, effective April 12, 1999, securitizers are required to hold the greater of 2 percent of the nonguaranteed portion of loans or two times their loss rate on SBA loans over the preceding ten years. This provision helps keep lenders accountable for the losses on loans they originate. Based on the most recent loss rate experience of the forty highest-volume SBA lenders, securitizers on average would need to keep 5.4 percent. This requirement is unlikely to materially alter the rate of securitization because most of the issuers in recent years have retained roughly a 5 to 10 percent subordinated part of the package.

The final rule also provides an incentive for securitizers to continue to service and underwrite loans prudently by threatening to remove PLP status. A securitizer's "currency rate"--that is, the dollar balance of its 7(a) guaranteed loans that are less than thirty days overdue divided by the dollar balance of its portfolio of 7(a) guaranteed loans outstanding--is calculated and compared with the currency rate for all SBA 7(a) loans. Each quarter, the securitizer's currency rate is reviewed to see if it has deteriorated. In particular, the securitizer is placed on

[13] The FDIC rule amends 12 C.F.R. pt. 360.

[14] Federal Register, vol. 65, no. 46 (March 8, 2000), p. 12320.

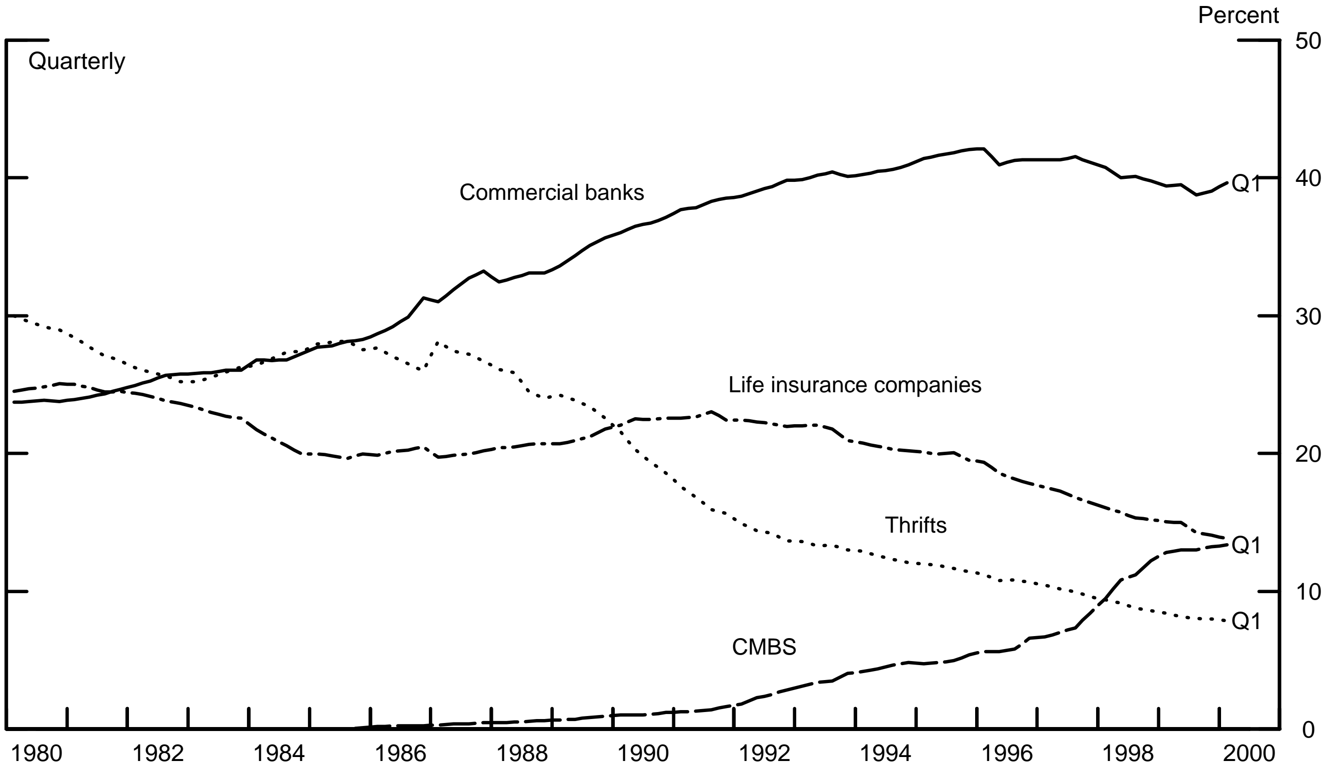
probation if two conditions occur:

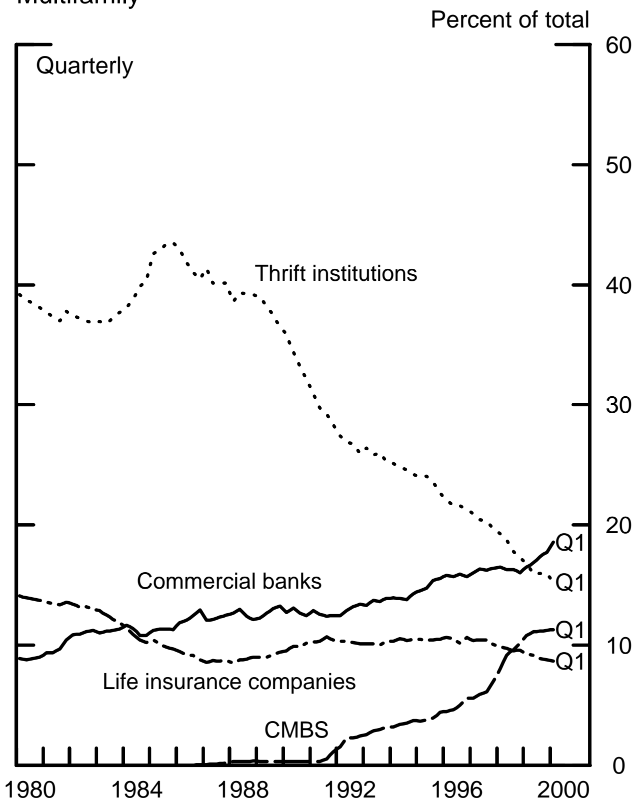
- the securitizer's currency rate has fallen below its initial quality rating by more than a benchmark number set by the SBA, currently 2.5 percentage points; and
- its currency rate has deteriorated relative to the overall loan quality of the entire SBA 7(a) guaranteed loan portfolio.

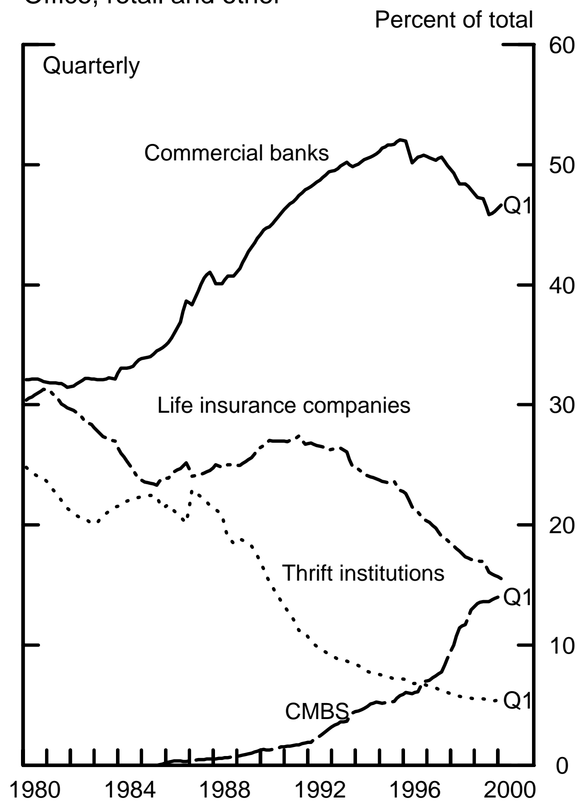
If at the end of the probationary quarter both conditions are still met, the SBA suspends the securitizer's PLP approval privileges and will not approve additional securitization requests. This regulation intends to ensure the origination of high-quality loans by lenders who securitize the nonguaranteed portion of 7(a) loans. However, some market observers have noted that the threat of losing PLP status could deter lenders from participating in a securitization, as the PLP renewal is only biennial for those who do not securitize.

Exhibit 1

Direct Holdings of Commercial Mortgage Loans, by Major Holder*





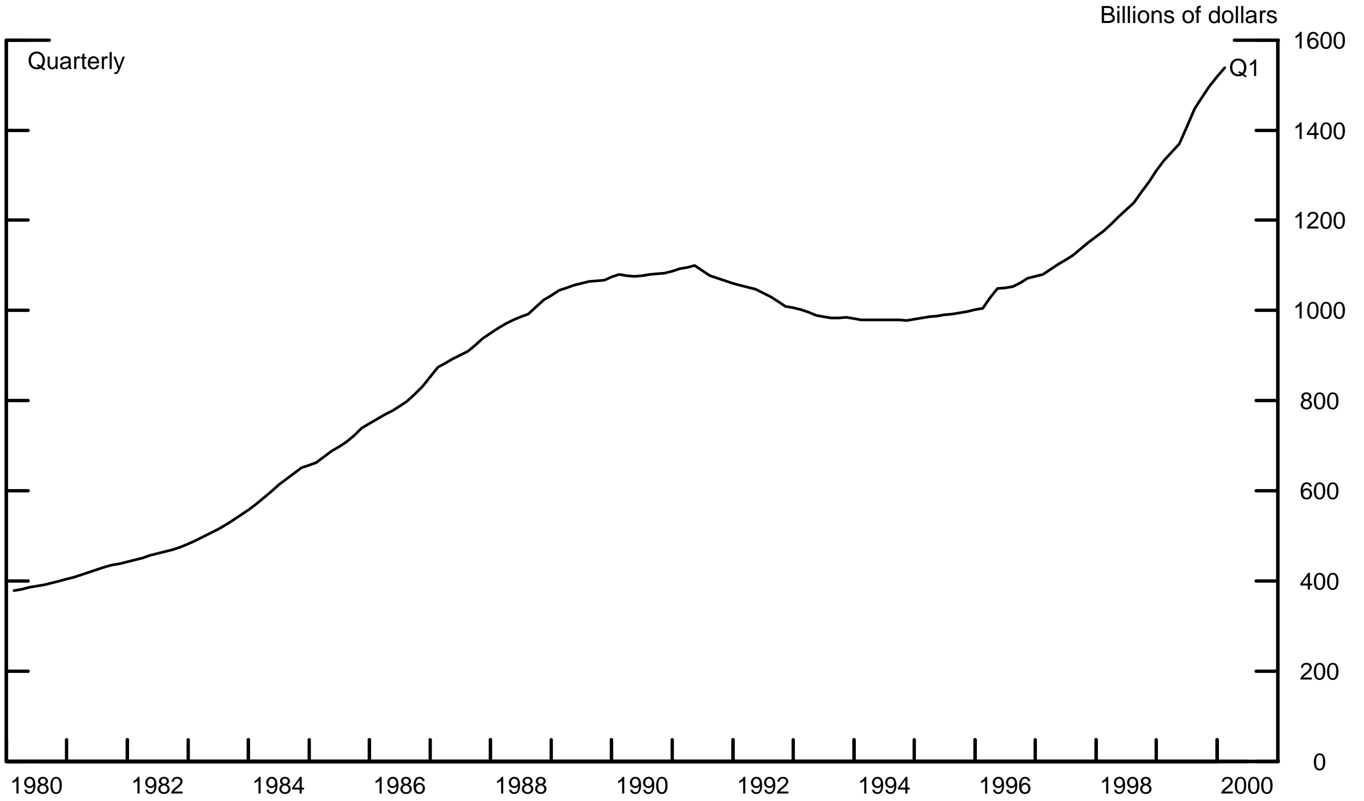


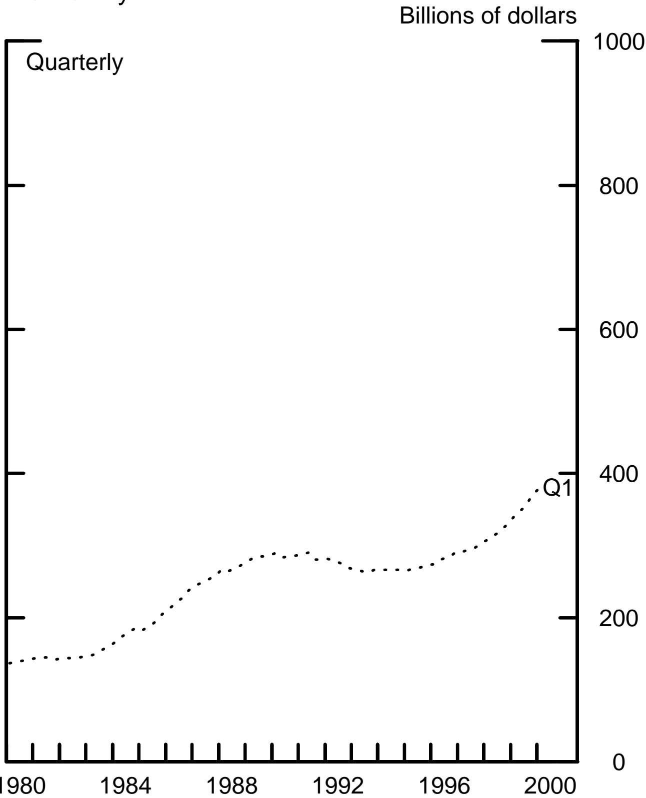
Source. Federal Reserve Board Flow of Funds Accounts.

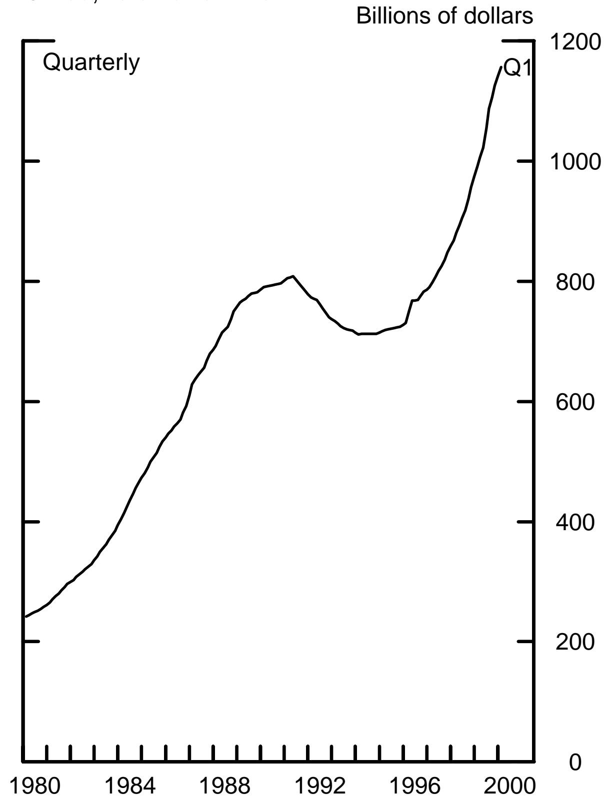
* Other holders of commercial mortgages (not shown) include: Pension funds, GSE Pools, REITS and other financial and non-financial intermediaries.

Exhibit 2

Commercial Mortgage Debt Outstanding





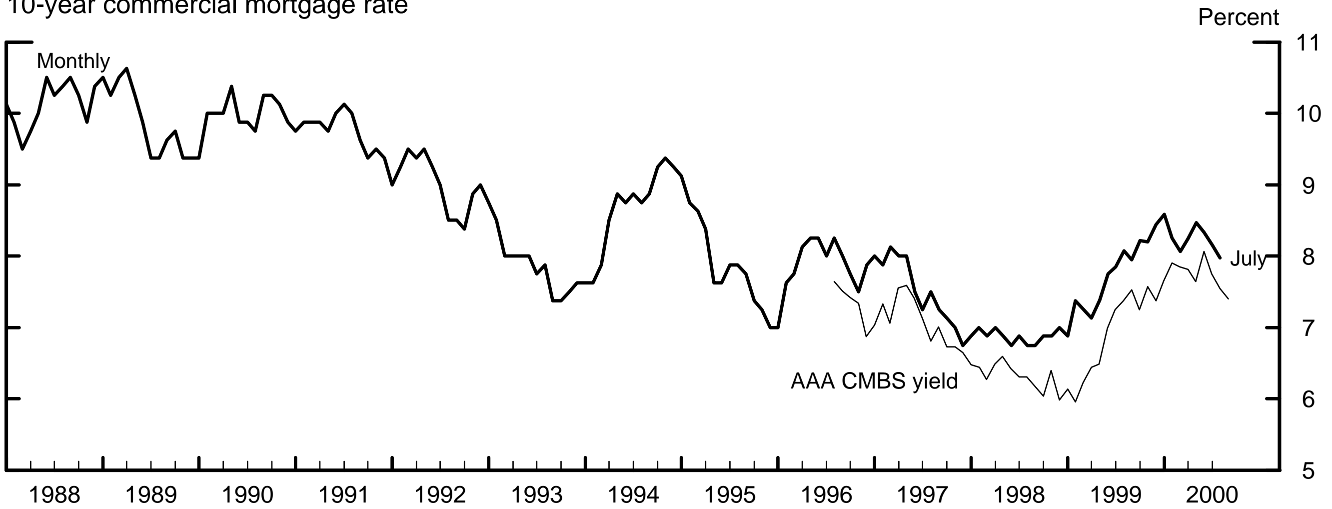


Source. Federal Reserve Board Flow of Funds Accounts.

Exhibit 3

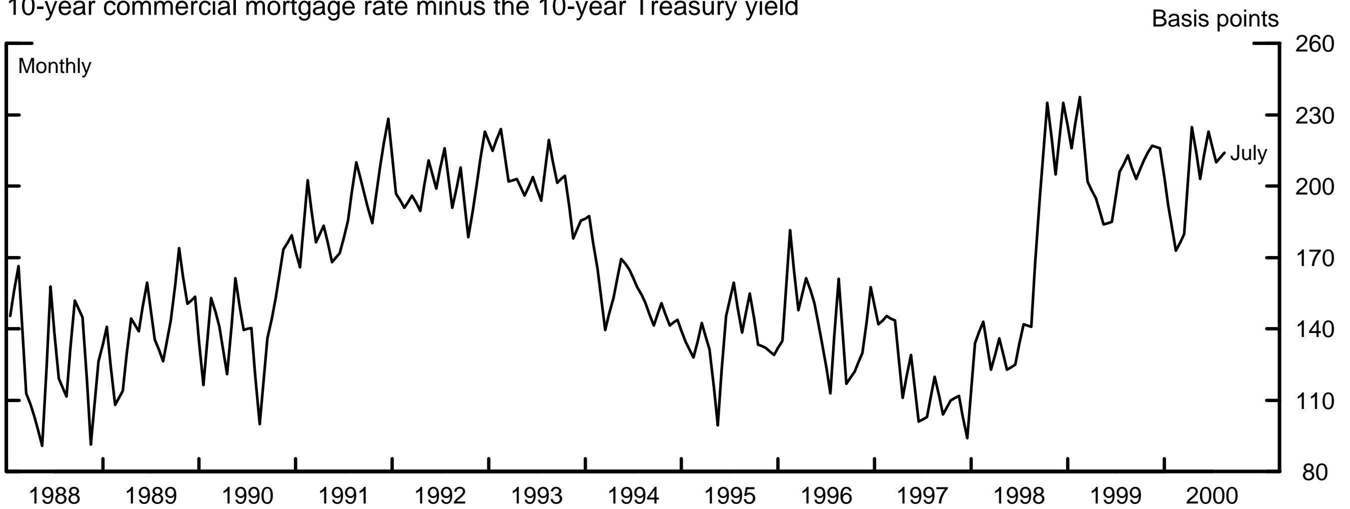
Commercial Mortgage Interest Rates and Loan Delinquency Rates

10-year commercial mortgage rate



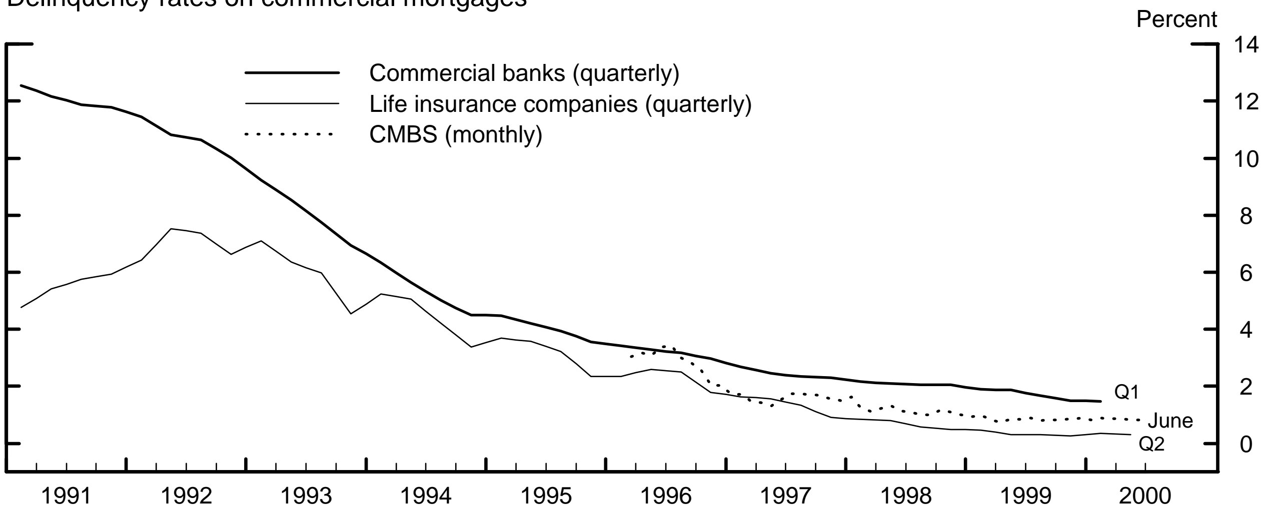
Sources. Barron's/Levy National Mortgage Survey, Morgan Stanley.

10-year commercial mortgage rate minus the 10-year Treasury yield



Source. Barron's/Levy National Mortgage Survey.

Delinquency rates on commercial mortgages

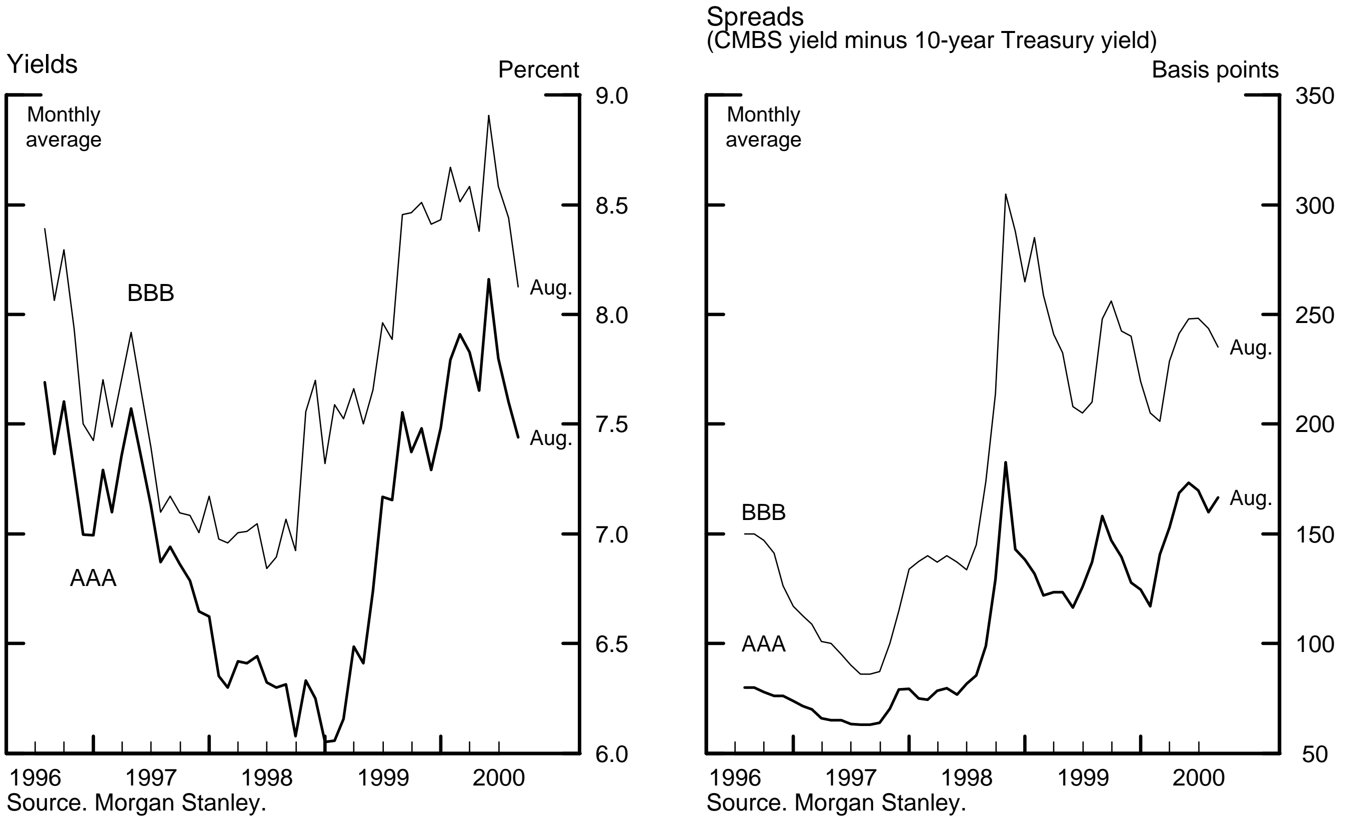


Sources. American Council of Life Insurance, Morgan Stanley, Call Reports.

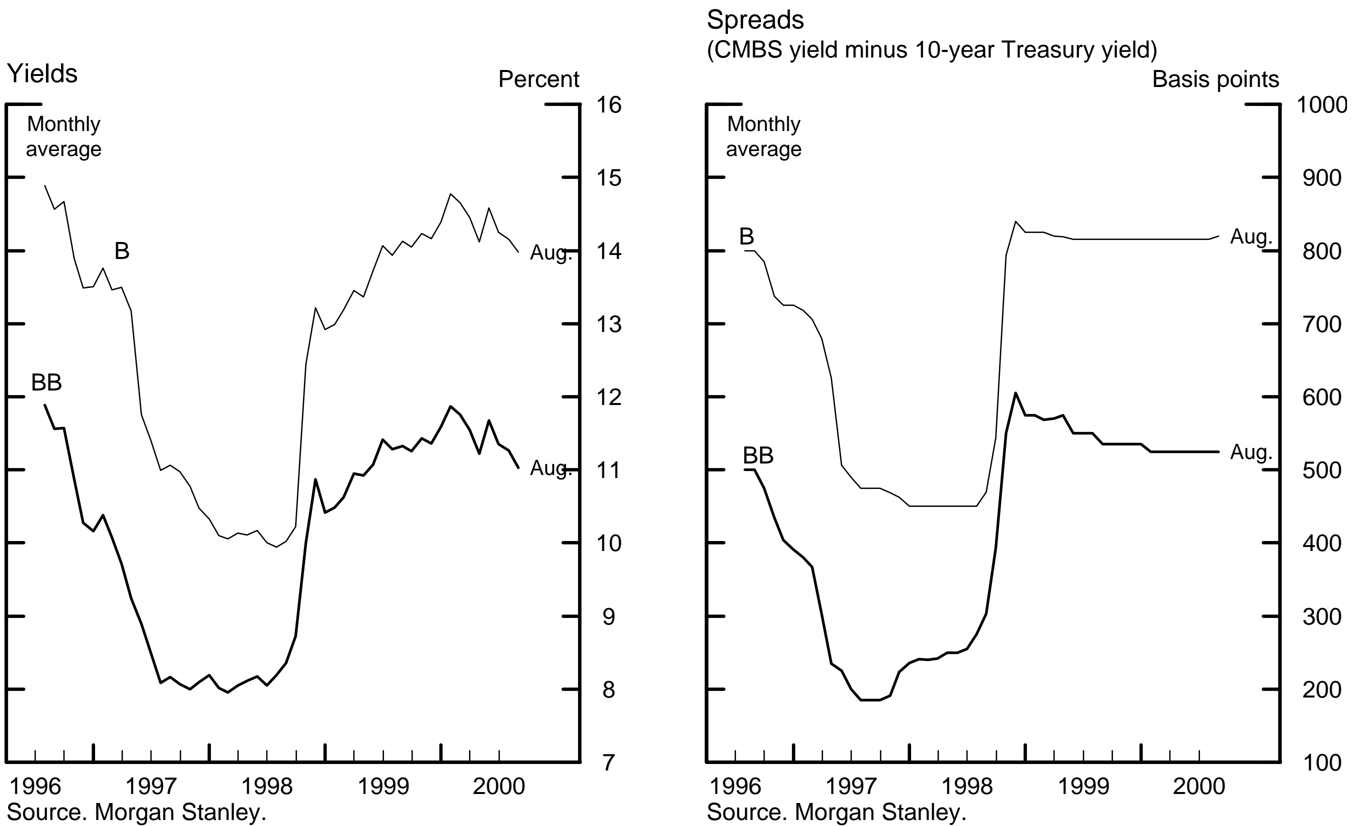
Exhibit 4

CMBS Spreads and Yields

Investment Grade



Non-Investment Grade



Net Flows of Commercial Real Estate Debt and Equity Financing, by Source
Billions of dollars; fourth quarter to fourth quarter

Type and source of financing	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000[1]
Mortgage loans outstanding	**-17.0**	**-55.9**	**-36.8**	**-6.6**	**20.1**	**40.0**	**78.6**	**135.9**	**177.1**	**161.5**
Multifamily	-3.9	-12.4	-4.5	-0.5	7.7	12.1	13.3	27.0	42.4	36.1
Office, retail and other	-13.1	-43.5	-32.2	-6.2	12.4	27.9	65.2	108.9	134.7	125.4
Loans held by:										
Financial intermediaries	**-36.1**	**-57.5**	**-35.7**	**-10.3**	**13.8**	**17.7**	**25.9**	**45.2**	**110.4**	**117.9**
Commercial Banks	8.6	-8.6	-7.1	5.5	19.6	23.1	29.9	38.5	73.3	101.2
Thrifts	-34.4	-28.6	-9.9	-9.9	-4.2	0.2	-3.5	-0.4	9.5	4.7
Life insurance companies	-5.3	-17.3	-15.7	-8.2	-3.1	-3.5	-1.9	6.3	13.3	10.1
Pension Funds	-4.6	-3.0	-2.0	3.0	1.3	1.6	2.1	3.1	2.5	1.5
Other[2]	-0.5	-0.1	-1.0	-0.7	0.1	-3.7	-0.7	-2.4	11.7	0.4
Securitized	**1.2**	**9.3**	**9.1**	**9.3**	**10.1**	**20.7**	**34.6**	**73.6**	**49.4**	**34.0**
GSE mortgage pools[3]	-2.6	-2.3	-1.4	0.0	4.5	5.6	5.3	10.5	9.2	6.5
Private mortgage pools (CMBS)	4.5	11.3	11.0	7.4	6.7	16.5	26.2	60.6	41.1	28.3
REITs	-0.7	0.3	-0.6	1.9	-1.1	-1.4	3.1	2.6	-1.0	-0.8
Other	**17.9**	**-7.8**	**-10.2**	**-5.6**	**-3.8**	**1.5**	**18.1**	**17.2**	**17.4**	**9.6**
State and local governments	1.5	0.6	0.6	1.3	0.1	1.6	0.7	0.8	0.8	0.8
U.S. government agencies	16.7	-10.8	-9.0	-9.8	-7.7	-4.2	-1.6	-0.2	0.6	-3.3
GSE portfolio holdings	1.0	1.6	1.7	0.9	0.6	-0.5	-1.2	0.8	4.6	5.2
Nonfinancial business	-1.2	-0.1	-4.4	2.2	2.3	4.0	20.1	15.5	11.1	6.6
Noprofit organizations	-0.1	0.9	0.9	-0.1	0.9	0.5	0.1	0.2	0.3	0.3
Memo:										
Net REIT equity issuance	1.6	2.0	13.2	11.1	8.7	12.3	32.5	19.8	6.6	2.6

1. Data as of 2000:Q1 at an annual rate
2. Includes finance companies, mortgage companies, and other insurance companies.
3. Government National Mortgage Association, Federal National Mortgage Association, Federal Home Loan Mortgage Corporation, and Farmers Home Administration pools.

Source. Federal Reserve Board Flow of Funds Accounts.

Total Outstanding Commercial Real Estate Debt and Equity Financing, by Source
Billions of dollars; end of period

Type and source of financing	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000[1]	Memo: Change 1991-2000[1]
Mortgage loans outstanding	**1065.5**	**1009.5**	**984.5**	**977.9**	**998.0**	**1071.7**	**1150.2**	**1286.2**	**1497.8**	**1538.1**	**472.7**
Multifamily	281.7	269.3	266.2	265.8	273.4	289.2	302.5	329.5	372.2	381.2	99.5
Office, retail and other	783.7	740.2	718.3	712.1	724.6	782.5	847.7	956.6	1125.6	1156.9	373.2
Loans held by:											
Financial intermediaries	**856.9**	**799.5**	**763.8**	**753.5**	**767.3**	**818.7**	**844.6**	**889.8**	**1001.7**	**1031.1**	**174.2**
Commercial Banks	410.4	401.8	394.7	400.2	419.8	442.9	472.8	511.4	584.7	610.0	199.6
Thrifts	166.6	138.0	128.1	118.3	114.1	114.3	110.8	110.4	119.9	121.0	-45.6
Life insurance companies	238.8	221.6	205.9	197.7	194.6	191.1	189.2	195.5	210.4	212.9	-25.9
Pension Funds	27.4	24.4	22.3	25.4	26.6	28.3	30.4	33.5	36.0	36.4	9.0
Other[2]	13.7	13.6	12.7	12.0	12.1	42.1	41.4	39.0	50.7	50.8	37.1
Securitized	**50.3**	**59.6**	**68.7**	**78.0**	**88.1**	**108.8**	**143.4**	**217.0**	**266.4**	**274.9**	**224.6**
GSE mortgage pools[3]	26.1	23.8	22.5	22.4	26.9	32.5	37.8	48.3	57.5	59.1	33.0
Private mortgage pools (CMBS)	17.5	28.8	39.9	47.3	54.0	70.5	96.7	157.2	198.3	205.4	187.9
REITs	6.6	6.9	6.4	8.3	7.2	5.8	8.9	11.5	10.6	10.4	3.7
Other	**158.3**	**150.5**	**152.1**	**146.5**	**142.6**	**144.1**	**162.3**	**179.4**	**229.7**	**232.1**	**73.9**
State and local governments	49.3	49.9	50.5	51.8	51.9	53.5	54.2	55.0	55.8	56.0	6.7
U.S. government agencies	53.0	42.2	45.0	35.2	27.5	23.3	21.8	21.6	55.1	54.3	1.2
GSE portfolio holdings	14.2	15.8	17.5	18.4	19.0	18.6	17.3	18.1	22.7	24.0	9.8
Nonfinancial business	38.9	38.8	34.4	36.6	38.9	43.0	63.0	78.6	89.7	91.3	52.4
Noprofit organizations	2.8	3.7	4.6	4.5	5.3	5.9	6.0	6.2	6.5	6.5	3.8
Memo:											
Cumulative REIT equity issuance	20.5	22.5	35.7	46.8	55.4	67.7	100.3	120.1	126.6	127.4	106.9

1. Data as of 2000:Q1 at an annual rate
2. Includes finance companies, mortgage companies, and other insurance companies.
3. Government National Mortgage Association, Federal National Mortgage Association, Federal Home Loan Mortgage Corporation, and Farmers Home Administration pools.

Source. Federal Reserve Board Flow of Funds Accounts.

Exhibit 7

Gross Issuance of CMBS, by Property Type and Rating Class

Percent of total issuance

CMBS issued	1996	1997	1998	1999	2000 [1]
By property type					
Retail	30.3	31.8	28.4	30.5	28.2
Office	21.8	24.7	22.3	22.9	33.7
Multifamily	23.7	20.4	21.1	20.1	15.6
Other	24.2	23.1	28.2	26.4	22.5
By rating class					
Rated	**98.1**	**98.1**	**99.7**	**99.9**	**100.0**
AAA	50.8	61.0	63.6	67.3	61.8
AA	19.4	10.4	7.2	7.8	6.6
A	8.0	6.7	6.1	7.3	7.8
BBB	7.5	7.1	7.6	6.6	8.0
Below BBB	6.5	3.6	4.3	4.0	3.6
No rating given	5.1	8.1	9.7	6.2	7.3
IO strips [2]	0.8	1.3	1.2	0.8	5.0
Unrated [3]	**1.9**	**1.9**	**0.3**	**0.1**	**0.0**
Memo: Total, millions of dollars	**26,365**	**36,798**	**74,332**	**56,571**	**40,235**

1. Through June 2000, at an annual rate.
2. Most interest-only strips carry a AAA rating.
3. Includes lease-backed transactions, which carry the explicit credit ratings of tenants.
Source. *Commercial Mortgage Alert.*

Gross Issuance of CMBS, by Credit-Rating Firm and Type of Offering, Loan Origination, and Seller/Borrower

Percent of total issuance

CMBS issued	1996		1997		1998		1999		2000 [1]	
	Deal share	Dollar share	Deal share	Dollar share	Deal share	Dollar share	Deal share	Dollar share	Deal share	Dollar share
By credit-rating firm										
Rated [2]	**87**	**98**	**84**	**98**	**86**	**100**	**97**	**100**	**100**	**100**
Moody's	18	31	48	76	63	75	63	74	66	76
Standard & Poor's	48	62	42	63	49	61	63	59	47	51
Fitch	48	64	47	65	33	54	48	53	68	71
Duff & Phelps	28	41	24	33	20	25	23	27	13	11
Unrated [3]	**13**	**2**	**16**	**2**	**14**	**0**	**3**	**0**	**0**	**0**
By type of offering										
Public	-	50	-	66	-	72	-	70	-	55
Private	-	50	-	34	-	28	-	30	-	45
By loan origination type										
For securitization	-	69	-	90	-	98	-	95	-	100
Other	-	31	-	10	-	2	-	5	-	0
By type of seller / borrower										
Securitization program	-	44	-	72	-	94	-	75	-	80
REIT	-	4	-	5	-	2	-	6	-	9
Developer	-	11	-	3	-	1	-	4	-	0
Investment bank	-	4	-	6	-	0	-	4	-	0
Investment group	-	5	-	4	-	1	-	4	-	6
Bank/Thrift	-	4	-	4	-	1	-	3	-	0
Insurance company	-	17	-	5	-	0	-	3	-	0
Other	-	11	-	1	-	1	-	2	-	0
Memo:										
Total, number of deals	94	-	79	-	81	-	92	-	76	-
Total, millions of dollars	-	26,365	-	36,798	-	74,332	-	56,571	-	40,234

1. Through June 2000, at an annual rate.
2. Details do not sum to total because individual deals may be rated by more than one credit-rating firm.
3. Includes lease-backed transactions, which carry the explicit credit ratings on tenants.
4. Other includes pension funds, finance/mortgage companies, retailers, RTC/FDIC, and firms not classified.

Source. *Commercial Mortgage Alert*.

Exhibit 9

Growth of Small-Business Loans at U.S. Commercial Banks[1]

Year	Type of Loan		
	Total business	Commercial and industrial	Nonfarm, nonresidential real estate
	Amount outstanding, June 30 (billions of dollars)		
1994	257.6	134.4	123.2
1995	280.9	146.5	134.4
1996	300.1	157.3	142.8
1997	318.7	169.4	149.3
1998	340.8	179.4	161.4
1999	368.1	191.0	177.2
2000[2]	404.8	209.5	195.3
	Percentage change, June to June		
1994	--	--	--
1995	9.0	9.0	9.1
1996	6.8	7.4	6.3
1997	6.2	7.7	4.6
1998	6.9	5.9	8.1
1999	8.0	6.5	9.8
2000[2]	10.0	9.7	10.2

1. Business loans of $1 million or less at U.S. domestically chartered commercial banks, excluding U.S. branches and agencies of foreign banks.

2. Preliminary.

Source. June 30 Call Reports.

Exhibit 10

Characteristics of Securities Backed by Small-Business Loans[1]

Volume in millions of dollars

Year	Number	Total volume	Issues backed by SBA 7(a) loans	Issues backed by conventional loans
1992	2	574	51	523
1993	3	376	76	300
1994	3	202	157	45
1995	6	241	142	99
1996	9	642	258	384
1997	11	718	290	428
1998	12	1220	282	938
1999	16	2312	444	1868
2000[2]	2	101	36	65
Total	64	6386	1736	4650

1. Includes securities backed by the unguaranteed portion of SBA loans, but excludes those backed by the guaranteed portion.

2. Includes data through June 2000.

Sources. Moody's Investors Service, First Union Securities, and the Small Business Administration.

Exhibit 11

Small-Business-Loan-Backed Securitizations, by Seller
Millions of dollars

Seller	Year							
	1993	1994	1995	1996	1997	1998	1999	Total
Nonbank financial firms								
The Money Store[1]	76	130	125	240	290	90	690	1,641
Fremont Financial[2]	300	0	30	135	109	0	0	574
PMC Capital	0	27	0	71	23	108	56	285
AMRESCO	0	0	0	0	34	280	761	1,075
Other[3]	0	0	86	237	211	122	175	831
Commercial banks								
Zions First	0	45	0	0	0	0	212	257
SierraWest Bank[4]	0	0	0	0	51	85	195	331
First Source Corp	0	0	0	0	0	400	0	400
First Intn'l Bank	0	0	0	0	0	92	163	255
Bank of Yorba Linda	0	0	0	0	0	43	60	103
Total	376	202	241	683	718	1,220	2,312	5,752
Memo: Number of issues	3	3	6	9	11	12	16	60

1. The Money Store merged with First Union National Bank in 1998 and is now known as First Union Small Business Capital.
2. Fremont Financial was acquired by FINOVA Group in late 1999.
3. Includes small issues sold by: American Business Credit, Business Loan Center, Carolina First, Concord Finance, Emergent Business Capital, First City Financial, Heller First Capital, J-Hawke, National Cooperative Bank, and PrinVest Corp.
4. SierraWest Bank was acquired by BankWest Corp. in 1999.

Source. Compiled from a published report prepared by First Union and information obtained from the SBA, the rating agencies, individual issuers, and published sources. Some placements may have been missed.

Exhibit 12

Small-Business Loans Transferred with Recourse by Commercial Banks[1]

Millions of dollars

Quarter	Outstanding principal balance	Amount of retained recourse	Number of banks
1998:Q1	151.0	23.5	5
Q2	142.1	22.9	6
Q3	210.9	27.5	7
Q4	184.1	24.9	6
1999:Q1	176.8	23.9	8
Q2	478.6	53.7	8
Q3	518.3	85.7	7
Q4	506.3	66.7	7
2000:Q1	513.4	54.6	7
Q2[2]	469.2	51.9	7

1. Recourse refers to the part of the pool of loans that is retained by the bank. This portion of the pool is in a “first loss” position, that is, any shortage in the cumulative repayments on loans in the pool is deducted from the recourse. The Riegle Act allows banks to hold capital against only the recourse that is retained rather than the entire pool.

2. Preliminary.

Source. Call Reports.

Exhibit 13

Small Business Administration 7(a) Loans

Millions of dollars

Year	Originated[1]			Securitized[1]		
	Total	Guaranteed part	Nonguaranteed part	Total	Guaranteed part	Nonguaranteed part
1994	8,177	5,993	2,184	2,457	2,300	157
1995	8,257	5,995	2,262	2,042	1,900	142
1996	7,695	5,736	1,959	2,667	2,409	258
1997	9,462	6,007	3,455	2,993	2,703	290
1998	9,016	6,181	2,835	3,074	2,792	282
1999	10,146	6,733	3,413	3,673	3,229	444
2000[2]	10,555	6,917	3,638	3,706	3,634	72

1. Volumes originated are for the fiscal year that ends in September. Volumes securitized are for the calendar year.

2. Through June 2000, at an annual rate.

Source. Small Business Administration.

APPENDIX A
SECTION 209 OF THE RIEGLE COMMUNITY DEVELOPMENT AND REGULATORY IMPROVEMENT ACT OF 1994

Joint Study on the Impact of Additional Securities Based on Pooled Obligations

(a) **Joint study required.** The Board and the Commission shall conduct a joint study of the impact of the provisions of this subtitle (including the amendments made by this subtitle) on the credit and securities markets. Such study shall evaluate–

(1) the impact of the provisions of this subtitle on the availability of credit for business and commercial enterprises in general, and the availability of credit in particular for–

(A) businesses in low- and moderate-income areas;
(B) businesses owned by women and minorities;
(C) community development efforts;
(D) community development financial institutions;
(E) businesses in different geographical regions; and
(F) a diversity of types of businesses;

(2) the structure and operation of the markets that develop for small business related securities and commercial mortgage related securities, including the types of entities (such as pension funds and insurance companies) that are significant purchasers of such securities, the extent to which such entities are sophisticated investors, the use of credit enhancements in obtaining investment-grade ratings, any conflicts of interest that arise in such markets, and any adverse effects of such markets on commercial real estate ventures, pension funds, or pension fund beneficiaries;

(3) the extent to which the provisions of this subtitle with regard to margin requirements, the number of eligible investment rating categories, preemption of State law, and the treatment of such securities as government securities for the purpose of State investment limitations, affect the structure and operation of such markets; and

(4) in view of the findings made pursuant to paragraphs (2) and (3), any additional suitability or disclosure requirements or other investor protections that should be required.

(b) **Reports.**

(1) In General. The Board and the Commission shall submit to the Congress a report on the results of the study required by subsection (a) before the end of–

(A) the 2-year period beginning on the date of enactment of this Act;
(B) the 4-year period beginning on such date of enactment; and
(C) the 6-year period beginning on such date of enactment.

(2) Contents Of Report. Each report required under paragraph (1) shall contain or be accompanied by such recommendations for administrative or legislative action as the Board and the Commission consider appropriate and may include recommendations regarding the need to develop a system for reporting additional information concerning investments by the entities described in subsection (a)(2).

(c) **Definitions.** As used in this section–
(1) the term "Board" means the Board of Governors of the Federal Reserve System:
(2) the term "Commission" means the Securities and Exchange Commission.

APPENDIX B
RISK-BASED CAPITAL REQUIREMENTS[1]

Commercial-Mortgage-Related Securities. For some lenders and investors, risk-based capital requirements favor the holding of investment-grade securities rather than whole loans. For thrift institutions, securities that qualify under SMMEA are eligible for a 20 percent risk weighting instead of 100 percent, a weighting that reduces the capital charge on these securities to 1.6 percentage points from 8 percentage points. Life insurance companies have also been given a capital incentive to hold mortgages as investment-grade securities rather than as whole loans. Risk-based capital guidelines established by the National Association of Insurance Commissioners set the capital charge for commercial real estate loans between 1.5 percentage points and 9 percentage points--depending on the individual insurance company's historical mortgage delinquency experience--but only between 0.3 percentage point and 1 percentage point for investment-grade securities, including securitized commercial mortgages. Thus, some life insurance companies may choose to originate commercial mortgages, pool these loans for securitization, and retain only those classes of securities that incur the lower capital charges.

For banks, capital charges currently are not reduced when commercial mortgages (and most other assets) are held in the form of securities rather than as whole loans. Under existing risk-based capital standards, both commercial mortgages and CMBS are generally assigned to the 100 percent risk-weight category, resulting in a capital charge of 8 percent of the face amount of the asset on the bank's balance sheet.[2] However, section 350 of the Riegle Act required bank regulators to limit the amount of risk-based capital an insured depository institution is required to hold for assets transferred with recourse, including commercial mortgages. In particular, the amount of risk-based capital required to be maintained by any insured depository institution with respect to assets sold with recourse may not exceed the maximum amount of recourse for which the institution is contractually liable under the recourse agreement. This provision corrected an anomaly that existed in the risk-based capital treatment of recourse transactions under which an institution could be required to hold capital in excess of the maximum amount of loss possible under the contractual terms of the recourse obligation.[3]

For example, if a bank originates a $100 million pool of commercial mortgages, the capital charge would be $8 million. If the bank (acting as sponsor) securitizes the loans and retains a first-dollar loss position that provides credit enhancement to more senior securities, required capital equals the full capital charge against the underlying loans as if they had remained on the bank's balance sheet (again, 8 percent), subject to the limit that capital charges not exceed the bank's maximum credit exposure under

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[1] This appendix is taken from the 1996 Report with appropriate updates.

[2] In August 1996, the Federal Reserve Board implemented an amendment to its risk-based capital guidelines for state member banks and bank holding companies that incorporates a measure for market risk and requires banks with significant trading activity to hold capital to support the "general market risk" and "specific risk" associated with its debt and equity positions in the trading account. Institutions covered by the new rule were required to comply no later than January 1, 1998. Debt and equity positions included in the market risk measure would be excluded from the credit risk capital requirements. Capital charges for specific risk are based on the identity of the obligor and, in the case of corporate securities, on the credit rating and remaining maturity of the instrument. Thus, banks affected by the rule have an opportunity to reduce their total capital requirements by holding highly rated securities rather than loans in their trading accounts.

In addition, banking agencies proposed reducing capital charges for triple-A-rated senior securities backed by any form of underlying asset, including small-business loans and commercial mortgages. See Federal Register, Volume 65, No. 46, March 8, 2000, p. 12320. Under current bank capital guidelines, mortgage-backed securities issued by Ginnie Mae are assigned a 0 percent risk weight, while those issued by Fannie Mae and Freddie Mac are assigned a 20 percent risk weight.

[3] The Federal Reserve Board enacted regulatory amendments, effective March 22, 1995, to its capital adequacy guidelines for state member banks and bank holding companies that implement section 350 of the Riegle Act. (See Federal Register, vol. 60, no. 29 (February 13,1995), p. 8177.)

the recourse agreement. Thus, if the bank retains a $5 million C-class security as recourse, the capital charge would be only $5 million.[4]

Small-Business-Related Securities. To promote the securitization of small-business loans by banks, the Riegle Act instructed federal bank regulators to amend risk-based capital requirements for qualifying insured depository institutions that transfer small-business loans and leases on personal property with recourse. Section 208 of the Riegle Act states that such an institution shall include only the amount of retained recourse in its risk-weighted assets when calculating its capital ratios, provided two conditions are met. First, the transaction must be treated as a sale under generally accepted accounting principles (GAAP), and second, the depository institution must establish a noncapital reserve in an amount sufficient to meet the institution's reasonably estimated liability under the recourse arrangement. The aggregate amount of recourse retained in accordance with the provisions of the Riegle Act may not exceed 15 percent of an institution's total risk-based capital or a greater amount established by the appropriate federal banking agency.

A qualifying institution is defined as one that is *well capitalized* or, with the approval of the appropriate federal banking agency, *adequately capitalized*, as defined in the prompt corrective action statute. For purposes of determining whether an institution is qualifying, its capital ratios must be calculated without *regard* to the preferential capital treatment that section 208 sets forth for small-business obligations. The Riegle Act also states that the preferential capital treatment set forth in section 208 is not to be applied for purposes of determining an institution's status under the prompt corrective action statute (section 38 of the Federal Deposit Insurance Act). However, if an insured depository ceases to be a qualifying insured depository institution or exceeds the limits on its total outstanding amount of retained recourse noted above, the benefits of section 208 will remain applicable to any transfers of small-business loans or leases of personal property that occurred during the period when the institution was qualifying.[5]

Before this action, the entire amount of the assets sold with recourse had been included in the banking company's risk-weighted assets for calculating risk-based capital ratios. That is, banking organizations had been required to maintain capital against the full amount of assets transferred with recourse.

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[4] In addition, if a bank currently purchases a junior security issued by another sponsor, that security is not considered a recourse obligation of the purchasing bank and generally is assigned a capital charge of 8 percent of its face amount. Thus, the effective capital charge on a $5 million nonrecourse junior position would be $400,000.

[5] The Federal Reserve Board enacted regulatory amendments, effective September 1, 1995, to its capital adequacy guidelines for state member banks and bank holding companies that implement section 208 of the Riegle Act. (See Federal Register, vol. 60, no. 169 (August 31, 1995), p. 45612.)