

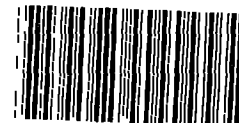
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UNITED STATES GENERAL ACCOUNTING OFFICE
WASHINGTON, D.C. 20548

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STATEMENT OF
JOHN LUKE, ASSOCIATE DIRECTOR
RESOURCES, COMMUNITY AND ECONOMIC DEVELOPMENT DIVISION

BEFORE THE
COMMITTEE ON SMALL BUSINESS
UNITED STATES SENATE
ON
THE SMALL BUSINESS ADMINISTRATION'S
SECONDARY MARKET PROCESS



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WE WELCOME YOUR INVITATION TO DISCUSS OUR APRIL 25, 1983, REPORT (GAO/RCED-83-96) ON THE SMALL BUSINESS ADMINISTRATION'S (SBA'S) 7(a) LOAN GUARANTEE PROGRAM AND ITS ROLE IN THE FINANCIAL MARKET. WE ARE PLEASED TO SEE THAT S. 2375 COVERS SEVERAL ISSUES WHICH WERE ADDRESSED IN OUR REPORT.

OUR REVIEW SHOWED THAT A VIABLE SECONDARY MARKET IN SBA GUARANTEED LOANS BENEFITS SMALL BUSINESSES AND HAS ADVANTAGES FOR LENDERS. HOWEVER, THE FULL POTENTIAL OF THE SECONDARY MARKET PROCESS HAS NOT BEEN REALIZED PARTLY BECAUSE SOME LENDERS ARE NOT FAMILIAR WITH THE PROCESS, SOME MAKE FEW SBA LOANS, AND SOME DO NOT HAVE LIQUIDITY PROBLEMS.

WE REPORTED THAT THE SECONDARY MARKET PROCESS NEEDED IMPROVEMENTS IN A NUMBER OF AREAS TO FURTHER BENEFIT SMALL BUSINESSES. I WILL NOW SUMMARIZE THE MAJOR BENEFITS AFFORDED SMALL BUSINESSES THROUGH THE SECONDARY MARKET, THOSE AREAS WHERE WE REPORTED THAT IMPROVEMENTS COULD BE MADE, OUR RECOMMENDATIONS FOR MAKING THESE IMPROVEMENTS, SBA'S ACTIONS TO IMPLEMENT OUR RECOMMENDATIONS AND OUR COMMENTS ON S. 2375.

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BENEFITS OF THE SECONDARY MARKET

OUR REVIEW SHOWED THAT THE SALE OF SBA-GUARANTEED LOANS IN THE SECONDARY MARKET BENEFIT SMALL BUSINESSES IN FOUR WAYS. FIRST, IT INCREASES THE LIKELIHOOD OF LENDERS WITH LIQUIDITY PROBLEMS MAKING LOANS TO SMALL BUSINESSES. NOT SURPRISINGLY, WE FOUND THAT THE ISSUE OF LIQUIDITY BECOMES INCREASINGLY IMPORTANT AS BANKS GET SMALLER. ABOUT 54 PERCENT OF SMALL BANKS USING THE SECONDARY MARKET INDICATED THAT, TO A GREAT EXTENT, LIQUIDITY WAS THE FACTOR THAT CAUSED THEM TO SELL. IN CONTRAST, ONLY 17 PERCENT OF LARGE BANKS USING THE SECONDARY MARKET INDICATED THAT, TO A GREAT EXTENT, LIQUIDITY WAS A FACTOR. THE SECONDARY MARKET ALSO OFFERS LENDERS A HEDGE AGAINST FUTURE LIQUIDITY PROBLEMS. OVER 20 PERCENT OF SMALL BANKS SAID THAT, TO A GREAT EXTENT, THEY USE THE SECONDARY MARKET FOR THIS PURPOSE.

SECOND, THE SECONDARY MARKET ENABLES LENDERS TO LEVERAGE CAPITAL AND MAKE MORE SMALL BUSINESS LOANS THAN OTHERWISE WOULD BE POSSIBLE. FOR EXAMPLE, DURING FISCAL YEARS 1979 THROUGH 1981, ABOUT \$1.5 BILLION IN SBA GUARANTEED LOANS WERE SOLD IN THE SECONDARY MARKET. AS A RESULT, WE ESTIMATED THAT ABOUT \$400 MILLION MAY HAVE BEEN RECYCLED TO SMALL BUSINESSES. THIS IS PARTICULARLY IMPORTANT BECAUSE THESE ADDITIONAL FUNDS WERE MADE AVAILABLE FROM INVESTORS, SUCH AS PENSION FUNDS AND INSURANCE COMPANIES, THAT DO NOT TYPICALLY INVEST DIRECTLY IN SMALL BUSINESSES.

THIRD, THE SECONDARY MARKET HAS THE POTENTIAL TO HELP SMALL BUSINESSES OBTAIN FIXED RATE LOANS. BECAUSE OF THE PROBLEMS THAT VARIABLE RATE LENDING CAUSES SMALL BUSINESSES DURING PERIODS OF VOLATILE INTEREST RATES, LENDERS HAVE USED THE SECONDARY MARKET TO MAKE FIXED RATE LOANS. THIS ALLOWS THE SMALL BUSINESS BORROWER TO

BUDGET FOR INTEREST EXPENSES MORE ACCURATELY. SOME LENDERS OFFER BORROWERS FIXED RATE FINANCING BY ARRANGING FORWARD PRICING COMMITMENTS WITH INVESTORS BEFORE MAKING THE LOAN TO THE SMALL BUSINESS. UNDER THIS ARRANGEMENT, THE INVESTOR AGREES TO PURCHASE THE LOAN AT A SPECIFIED RATE FOR A CERTAIN PERIOD.

FOURTH, THE SECONDARY MARKET PROCESS COULD LOWER INTEREST RATES. UNFORTUNATELY, OUR REVIEW DISCLOSED THAT THIS POTENTIAL BENEFIT HAS NOT OCCURRED TO ANY GREAT EXTENT DUE PRIMARILY TO A LACK OF SBA CONTROLS OVER BANK PROFITABILITY ON SECONDARY MARKET SALES. I WILL DISCUSS THIS POINT LATER ON IN MY STATEMENT.

WITH THESE BENEFITS IN MIND, I WILL NOW BRIEFLY COMMENT ON THOSE AREAS WHERE OUR REVIEW SHOWED THAT THE SECONDARY MARKET PROCESS COULD BE IMPROVED.

ADMINISTRATIVE PROBLEMS
AND INVESTOR CONCERNS
WITH THE SECONDARY MARKET

WE REPORTED THAT SBA DID NOT HAVE SPECIFIC GOALS AND OBJECTIVES FOR THE SECONDARY MARKET PROCESS NOR WERE CLEAR LINES OF AUTHORITY AND RESPONSIBILITY FOR ITS OVERSIGHT ESTABLISHED. THIS CAUSED CONFUSION OVER WHO WAS RESPONSIBLE FOR DIFFERENT ADMINISTRATIVE FUNCTIONS AND WHAT THE SECONDARY MARKET PROCESS CAN AND SHOULD ACCOMPLISH.

WE ALSO REPORTED THAT SBA WAS USING A MANUAL SYSTEM TO RECORD AND ACCOUNT FOR SECONDARY MARKET TRANSACTIONS. WE FOUND THAT THE REPORTING ACCURACY OF LOANS SOLD VARIED WIDELY AMONG SBA FIELD OFFICES AND IN AGGREGATE UNDERSTATED ACTUAL SALES BY ABOUT 20 PERCENT. MORE IMPORTANTLY, HOWEVER, WAS OUR FINDING THAT THE

FORMAT USED TO REPORT SECONDARY MARKET TRANSACTIONS CONTAINED ONLY LIMITED INFORMATION AND GENERALLY WAS NOT USED FOR MANAGEMENT OVERSIGHT.

WE FOUND THAT INVESTORS WERE ENCOUNTERING PROBLEMS WITH THEIR SBA LOANS THAT HURT THE REPUTATION OF THESE LOANS IN THE SECONDARY MARKET AND CAUSED SOME INVESTORS TO RECONSIDER PURCHASING ADDITIONAL LOANS. WE REPORTED THAT THE MOST SIGNIFICANT INVESTOR PROBLEM WAS RECONCILING PAYMENT DIFFERENCES BETWEEN THEIR RECORDS AND THOSE OF SBA'S FISCAL TRANSFER AGENT WHICH HANDLES ABOUT 50 PERCENT OF ALL SBA SECONDARY MARKET TRANSACTIONS. RECONCILIATION PROBLEMS WERE CAUSED PRIMARILY BY THE LACK OF A UNIFORM METHOD FOR COMPUTING INTEREST AND BECAUSE THE FISCAL TRANSFER AGENT HAD NO AUTHORITY TO GUARANTEE THE TIMELY PAYMENT OF INTEREST AND PRINCIPAL IN THE EVENT BANKS FAILED TO MAKE COMPLETE OR TIMELY PAYMENTS TO THEM. A SMALL BUSINESS COMMITTEE ON CAPITAL ACCESS, ASSEMBLED IN THE SUMMER OF 1982 UNDER THE DIRECTION OF THE SBA ADMINISTRATOR, STUDIED THE CONCERNS OF INVESTORS AND MADE SEVERAL RECOMMENDATIONS THAT, IF PROPERLY IMPLEMENTED, SHOULD ADDRESS MOST INVESTOR PROBLEMS.

SECONDARY MARKET'S EFFECT ON
SMALL BUSINESS BORROWING COSTS

SBA EXPECTED THAT, OVER TIME, USE OF THE SECONDARY MARKET WOULD RESULT IN LOWER BORROWING COSTS TO SMALL BUSINESSES. HOWEVER, OUR COMPARISON OF INTEREST RATES ON LOANS SOLD IN THE SECONDARY MARKET WITH THOSE NOT SOLD SHOWED NO SIGNIFICANT OVERALL DIFFERENCE IN THESE RATES.

ALTHOUGH SOME LENDERS HAVE USED THE PROCESS TO OFFER BORROWERS LOWER INTEREST RATES, OTHERS HAVE USED THE SECONDARY

MARKET TO SIGNIFICANTLY INCREASE THEIR YIELDS. YIELDS INCREASE BECAUSE INVESTORS ACCEPT A LESSER RATE OF INTEREST THAN THE BANK CHARGES THE BORROWER. THIS DIFFERENCE IS CALLED A SERVICING FEE. DEPENDING ON THE CIRCUMSTANCES OF THE SALE, YIELDS CAN BE VERY HIGH. FOR EXAMPLE, WE FOUND A SITUATION WHERE A BANK MADE A \$100,000 LOAN WITH A 90-PERCENT GUARANTEE. IN SELLING THE GUARANTEED PORTION OF THE LOAN, THE BANK RECEIVED ALMOST \$2,000 OVER THE FACE AMOUNT OF THE GUARANTEE (KNOWN AS A PREMIUM) AND A 3 3-PERCENT SERVICING FEE. THIS PREMIUM TOGETHER WITH THE SERVICING FEE TRANSLATED TO ABOUT A 60-PERCENT RETURN TO THE BANK DURING THE FIRST YEAR OF THE LOAN.

OUR CONVERSATIONS WITH BANK OFFICIALS DISCLOSED THAT THE AMOUNT OF LOAN SERVICING DONE VARIES FROM NEXT TO NOTHING TO DETAILED INVOLVEMENT WITH THE BORROWER. FURTHER, THE SERVICING FEE GENERALLY DOES NOT RELATE TO THE ACTUAL AMOUNT OF SERVICING DONE AND IN MOST CASES, IT IS SIMPLY THE DIFFERENCE BETWEEN THE INTEREST RATE CHARGED THE BORROWER AND THE RATE AT WHICH THE LOAN IS SOLD IN THE SECONDARY MARKET.

WE REPORTED THAT NO LIMITATION EXISTED ON THE AMOUNT OF SERVICING FEES THAT LENDERS CAN CHARGE ON SBA LOANS SOLD IN THE SECONDARY MARKET. OUR ANALYSIS OF OVER 3,000 LOANS SOLD IN THE SECONDARY MARKET DURING FISCAL YEARS 1979 THROUGH 1981 SHOWED WIDE VARIATIONS IN THE SERVICE FEES BEING CHARGED.

OUR RECOMMENDATIONS AND SBA ACTIONS

WE RECOMMENDED THAT THE SBA ADMINISTRATOR TAKE A NUMBER OF ACTIONS TO MAKE THE SECONDARY MARKET MORE EFFECTIVE IN HELPING SMALL BUSINESSES. SPECIFICALLY, WE REPORTED THAT THE SBA ADMINISTRATOR SHOULD

- ESTABLISH CLEAR GOALS AND OBJECTIVES FOR THE SECONDARY MARKET AND CLARIFY STAFF RESPONSIBILITIES FOR OVERSEEING THEIR IMPLEMENTATION.
- DEVELOP IMPROVED RECORDKEEPING CONTROLS OF SECONDARY MARKET TRANSACTIONS, INCLUDING SERVICE FEES AND PRICES PAID BY INVESTORS, AND DECIDE WHETHER THIS COULD BEST BE ACCOMPLISHED INTERNALLY OR BY USING THE SERVICES OF THE FISCAL TRANSFER AGENT.
- DEVELOP A STRATEGY FOR USING THE SECONDARY MARKET TO OFFER SMALL BUSINESSES FIXED RATE FINANCING. THE STRATEGY SHOULD CONSIDER THE USE OF LOAN POOLING.
- IMPLEMENT THE CAPITAL ACCESS COMMITTEE'S RECOMMENDATION THAT LENDERS STIPULATE THEIR METHODS OF ACCRUING INTEREST AND CONTINUE TO REMIT FUNDS ON THIS BASIS.
- IMPLEMENT THE CAPITAL ACCESS COMMITTEE'S RECOMMENDATION TO REQUIRE THE FISCAL TRANSFER AGENT TO REMIT INTEREST TO THE INVESTOR ON A 30/360 BASIS, IF SBA HAS SUCH AUTHORITY.
- REQUEST THE FISCAL TRANSFER AGENT TO PROPOSE HOW IT COULD FUNCTION AS A CENTRAL PAYING AGENT AND DECIDE WHETHER THIS PROPOSAL OR REQUESTING LENDERS TO REMIT PRINCIPAL AND INTEREST ON A TIMELY BASIS IS MORE PREFERABLE.
- TEST THE FEASIBILITY OF CONTROLLING SERVICING FEES BASED ON SPECIFIC LOAN CHARACTERISTICS, SHOULD THE ADMINISTRATOR DECIDE TO CONTROL SERVICING FEES.

SBA BASICALLY AGREED WITH OUR RECOMMENDATIONS AND CORRECTIVE ACTIONS ARE EITHER PLANNED OR UNDERWAY. HOWEVER, SOME OF THESE ACTIONS WILL NOT FULLY RESOLVE THE PROBLEMS CITED IN OUR REPORT. FOR INSTANCE, SBA IS NEGOTIATING WITH THE FISCAL TRANSFER AGENT FOR MORE DETAILED REPORTING ON SECONDARY MARKET TRANSACTIONS. HOWEVER, ABOUT 50 PERCENT OF SECONDARY MARKET SALES ARE HANDLED WITHOUT THE FISCAL TRANSFER AGENT. ACCORDINGLY, REPORTING PROBLEMS ARE LIKELY TO PERSIST AS SECONDARY MARKET TRANSACTIONS WILL BE RECORDED UNDER DUAL REPORTING SYSTEMS WITHOUT THE NECESSARY ASSURANCES OF UNIFORMITY. SBA HAS ALSO PROPOSED LIMITING SERVICING FEES TO 3 PERCENT TO LOWER SMALL BUSINESS INTEREST RATES. HOWEVER, AS LONG AS LENDERS ARE PERMITTED TO CHARGE INVESTORS PREMIUMS, THE BENEFIT OF CONTROLLING SERVICING FEES CAN BE CIRCUMVENTED.

GAO VIEWS ON S. 2375

I WOULD LIKE TO CONCLUDE MY STATEMENT BY COMMENTING ON SEVERAL PROVISIONS OF S. 2375, WHICH PROPOSES CHANGES TO THE SECONDARY MARKET. FIRST, THE BILL PROVIDES FOR THE POOLING OF SBA LOANS. OUR REPORT RECOMMENDED THAT LOAN POOLING BE CONSIDERED AS A MEANS OF OFFERING SMALL BUSINESSES THE OPTION OF FIXED RATE FINANCING. THE POOLING PROCESS SHOULD BE FACILITATED THROUGH THE BILL'S PROVISION THAT GUARANTEES INVESTORS THE TIMELY PAYMENT OF PRINCIPAL AND INTEREST.

SECOND, THE BILL REQUIRES THAT SBA DEVELOP PROCEDURES FOR THE ADMINISTRATION AND PROMOTION OF SECONDARY MARKET OPERATIONS. WE ALSO RECOMMENDED THIS. WE HOPE THAT CLEAR GOALS AND OBJECTIVES AND CLARIFIED STAFF RESPONSIBILITIES WILL BE PART OF THESE PROCEDURES.

LASTLY, THE BILL REQUIRES SBA TO PROVIDE FOR A CENTRAL REGISTRY FOR ALL LOANS SOLD IN THE SECONDARY MARKET. THE ESTABLISHMENT OF A CENTRAL REGISTRY IS CONSISTENT WITH OUR RECOMMENDATION FOR IMPROVING RECORDKEEPING CONTROLS OVER SECONDARY MARKET TRANSACTIONS.

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MR. CHAIRMAN, THIS CONCLUDES MY PREPARED STATEMENT. WE WILL BE GLAD TO RESPOND TO ANY QUESTIONS.