Proposed Rules

Federal Register
Vol. 63, No. 95
Monday, May 18, 1998

This section of the FEDERAL REGISTER contains notices to the public of the proposed issuance of rules and regulations. The purpose of these notices is to give interested persons an opportunity to participate in the rule making prior to the adoption of the final rules.

SMALL BUSINESS ADMINISTRATION

13 CFR Part 120

Business Loan Programs

AGENCY: Small Business Administration.

ACTION: Notice of proposed rulemaking and public hearing.

SUMMARY: The U.S. Small Business Administration (SBA) proposes a rule to allow all participating Lenders to sell, securitize, sell a participating interest in, or pledge the unguaranteed portion of 7(a) loans. The proposal has two components: securitizations; and pledges, sales of participations, and sales other than for the purpose of securitizing. In the first component, SBA establishes a three level unified approach to regulating securitization. This approach would apply to all securitizers and is designed to help ensure the safety and soundness of the 7(a) program. The approach focuses on the quality of the securitizer's underwriting and servicing and the performance of the securitizer's loans. In the second component, SBA sets forth the requirements that Lenders must meet to pledge, sell a participating interest in, or sell (other than for the purpose of securitizing) 7(a) loans. If this proposal becomes final, it would replace the present Interim Final Rule published on April 2, 1997, at 62 FR 15601 (the ''Interim Final Rule''). The proposed rule would amend 13 CFR § 120.420, add §§ 110.421–120.429, renumber §§ 120.430 and 120.431 as §§ 120.414 and 120.415, and add §§ 120.430–120.435. In addition, SBA is providing notice of a public hearing set for 2:00 p.m. on June 4, 1998. The hearing will provide the public an opportunity to comment orally on the proposed rule.

DATES: Submit comments July 17, 1998. SBA will hold a public hearing to receive oral comments on June 16, 1998, at 2:00 p.m. at the U.S. Small Business Administration, 409 Third Street, S.W., Washington, D.C., 8th Floor Eisenhower Conference Room.

ADDRESSES: Mail comments to Jane Palsgrove Butler, Acting Associate Administrator for Financial Assistance, U.S. Small Business Administration, 409 Third Street, S.W., Suite 8200, Washington, D.C. 20416.

FOR FURTHER INFORMATION CONTACT: James W. Hammersley, Director, Secondary Market Sales, 202–205–6490.

SUPPLEMENTARY INFORMATION: SBA is proposing a new regulation governing the securitization of the unguaranteed portion, sale, sale of a participating interest in, or pledge of SBA 7(a) loans. The rule has two components. The first component governs securitizations. For purposes of this regulation, a securitization is the pooling and sale of the unguaranteed portion of SBA loans, usually to a trust or special purpose vehicle, and the issuance of securities backed by those loans to investors in either a private placement or a public offering (''securitization''). In the securitizations of SBA loans to date, each investor has received an undivided ownership interest in the right to receive the principal of the unguaranteed portion of the pooled SBA loans, together with interest. As a credit enhancement, the securitizer usually transfers to the trust or special purpose vehicle, for the benefit of investors, a portion of the interest on each pooled loan representing the difference between the interest paid by the SBA loan borrower and the interest paid to the holder of the guaranteed interest, the holder of the securitized interest and various administrative fees (the ''Excess Spread'').

The second component of this proposed rule deals with pledges of, sales of participating interests in, and sales other than for the purpose of securitizing SBA loans.

I. Securitization Component

Regulatory History

Congress and SBA have examined whether and under what conditions SBA should permit Lenders to securitize the unguaranteed portion of 7(a) loans. Recognizing that Small Business Lending Companies and Business and Industrial Development Companies and other nondepository institutions (''nondepository institutions'') do not have customer deposits to fund 7(a) lending, SBA in 1992 began permitting nondepository Lenders to securitize. In 1996, Congress and SBA considered extending the authority to securitize to depository Lenders. On September 29, 1996, Congress enacted legislation requiring SBA, by March 31, 1997, either to promulgate a final rule allowing both nondepository and depository Lenders to securitize or cease approving securitizations.

In response to the legislative mandate, on November 29, 1996, SBA published an Advance Notice of Proposed Rulemaking (61 FR 60649) seeking public comments on securitizations in advance of its publication of proposed regulations. On February 26, 1997, SBA published a Proposed Rule (62 FR 8640) requiring a 5 percent retainage for all securitizations. SBA received approximately 25 comments; the commenters were divided almost equally in their response to SBA's proposal.

On April 2, 1997, SBA promulgated the Interim Final Rule (62 FR 15601). This regulation allowed all SBA Lenders to securitize while SBA continued its thorough review of securitization issues. Recognizing the complexity of the subject, SBA decided to hold a public hearing and consult bank regulators and other experts. While doing so, it has reviewed each proposed transaction on a case-by-case basis under the Interim Final Rule to protect the safety and soundness of the 7(a) program.

During its review process, SBA convened a public hearing at which interested parties publicly stated their views on securitization and related safety and soundness issues. SBA engaged securitization and accounting experts, and consulted representatives from bank and other financial regulatory agencies, including the Federal Deposit Insurance Corporation (FDIC), Office of the Comptroller of the Currency (OCC), Department of the Treasury, the Federal Reserve Board, Office of Federal Housing Enterprise Oversight and Office of Thrift Supervision (OTS).

SBA has carefully considered all views and comments expressed by these experts, bank regulators, and the industry, and has incorporated many of the comments and recommendations into a unified regulatory approach consisting of three levels. In January of 1998, SBA discussed its three level approach with representatives of the bank regulatory agencies.

SBA believes this proposal is an improvement over the Interim Final

Rule. The levels would apply uniformly, providing equal treatment to depository and nondepository institutions and addressing the possibility of increased risk to the SBA portfolio from securitization. The rule provides incentives for Lenders to maintain high underwriting and servicing standards to minimize delinquencies and defaults. Appropriately, the financial impact of the proposal on a particular securitizer would depend on the performance of the securitizer's loans. If the securitizer's loan performance has been good historically and remains consistent or improves during the period that a securitization is outstanding, the financial impact on the securitizer would be minimal. However, if a securitizer's loan performance has been below average historically or declines during the period that the securitization is outstanding, consequences to the securitizer would be greater. The new approach ties securitizer risk retention to securitizer long-term credit performance and considers the long-term credit cycle of SBA loans.

This proposed rule considers historic SBA loan data and is consistent with bank regulatory policy and marketplace risk management. The rule would facilitate the use of securitizations by setting forth clear and consistent standards. Compared to the Interim Final Rule, SBA believes the proposed rule would be better for taxpayers, better for Lenders, and better for small businesses.

Securitization Risks

SBA supports securitization because it encourages Lenders to make more SBA-guaranteed loans to America's small businesses. While securitization can provide enormous benefits, SBA has concerns that under certain circumstances or economic conditions the securitization process might encourage poor credit quality and increase SBA's losses on the guaranteed portion of its loans.

Securitization provides a market for large volume sales of SBA loans. Therefore, securitizers have an incentive to make loans quickly and record the profits from the securitization. Furthermore, if Excess Spread Income from previous securitizations declines, a securitizer might use the profits from new issues to offset the decline. These circumstances create a risk that securitizers might compromise credit quality in order to make more loans more quickly to increase profits.

Also, the securitization of the unguaranteed portions of small business loans is relatively new and has developed during the strong part of a business cycle. It is not clear what effect a downturn in the economy will have on the credit quality of individual securitizers and on the performance of securitized loans.

Under Financial Accounting Standards Board Statement Number 125 (''FASB 125''), a securitizer's earnings and capital grow faster than the earnings and capital of a non-securitizer making the same loans. FASB 125 requires Lenders that securitize loans and retain the servicing to recognize immediately the full amount of future income attributable to the securitized loans. This ''gain-on-sale'' income is calculated by discounting a stream of future income. The approach assumes an average life of the underlying loans, future servicing expenses, and loan losses. Securitization and FASB 125 have a direct effect on a securitizer's bottom line. The more loans a securitizer makes and the faster it makes them, the greater the securitizer's profits. Some experts have expressed concerns that this can lead to pressure for a securitizer to increase volume by potentially relaxing underwriting standards or reducing resources devoted to servicing. SBA's response to these concerns is to focus, through this proposed rule, on credit quality.

To control risk, SBA historically has relied on a Lender's retention of a significant economic interest in the unguaranteed portion of 7(a) loans. Lender risk retention has been the cornerstone of SBA's guarantee program. A Lender that sells the entire unguaranteed interest in a loan might be less accountable for losses because the unguaranteed portion is no longer available as a risk sharing mechanism.

Therefore, in its review, SBA has sought meaningful risk retention mechanisms that encourage securitizers to originate loans of appropriate credit quality while not discouraging securitization. SBA has analyzed a number of questions relating to such risk retention including: How should SBA structure risk retention to ensure that each Lender retains sufficient economic exposure to maintain high underwriting and servicing standards? Should SBA require securitizers to hold back a portion of their loans from securitization, retain subordinated securities issued in the securitization (a ''subordinated tranche''), or reserve cash? How much should the securitizer retain, purchase, or reserve? Who should determine the retainage amount, SBA or the rating agencies? What additional components should SBA require as a complement to a retention? Are there credit quality or loan performance standards which should trigger additional consequences? Supported by expert advice, SBA has now developed the following unified approach to regulating securitizations.

The Unified Regulatory Approach

This proposed rule does not rely solely on retention to encourage Lenders to maintain high credit quality and underwriting and servicing standards. Instead, it contains several progressive levels. The levels are:

(1) A consistent and enforceable capital requirement;

(2) A retention requirement (subordinated tranche); and

(3) Suspension of a securitizing PLP Lender's unilateral loan approval privileges (''PLP approval privileges'') if the currency rate (the percentage of loans that are less than 30 days past due) of the loans in the securitizer's portfolio deteriorates over time.

SBA believes this approach is superior to SBA's February 1997 securitization proposal that suggested a 5% retention requirement on all securitizers at the beginning of the securitization without regard to the securitizer's credit quality history or the subsequent performance of the securitized loans. The unified approach imposes a smaller economic impact on the securitizer initially, but establishes credit quality standards which, if not met during the life of a securitization, trigger increased scrutiny of the securitizer's underwriting. It provides securitizers with appropriate incentives tied to actual credit performance, affords SBA the protection it seeks for itself and taxpayers, and still facilitates securitization for all originators. A more detailed discussion of each level follows.

The Capital Requirement

A capital requirement is a basic component of the regulation of any financial institution. It is a common method for measuring a Lender's financial strength.

SBA is in the process of considering capital requirements for all its participating Lenders. Although maintenance of minimum capital is important for all SBA participating Lenders at all times, SBA believes the maintenance of minimum capital is especially important with respect to securitizers. Requiring the securitizer to maintain a minimum level of capital encourages prudent underwriting and servicing practices. Credit quality is fundamental to the maintenance of capital. Loan losses erode capital. As well as being a measure of reduced

financial strength, eroding capital may signal weakening credit quality.

To emphasize the significance SBA attaches to a securitizer's compliance with capital requirements, SBA has designated the maintenance of minimum capital as the first level of its unified approach for regulating securitization. The proposed rule would require all depository and nondepository securitizers to maintain minimum capital consistent with the requirements imposed on depository institutions by the Federal Reserve Board, the FDIC, the OCC, and the OTS (the ''bank regulatory agencies'').

For depository Lenders, SBA's capital requirement would not add to that which is already required by the bank regulatory agencies. Thus, this proposed rule should have no independent effect on depository institutions that already comply with capital requirements imposed by the bank regulatory agencies.

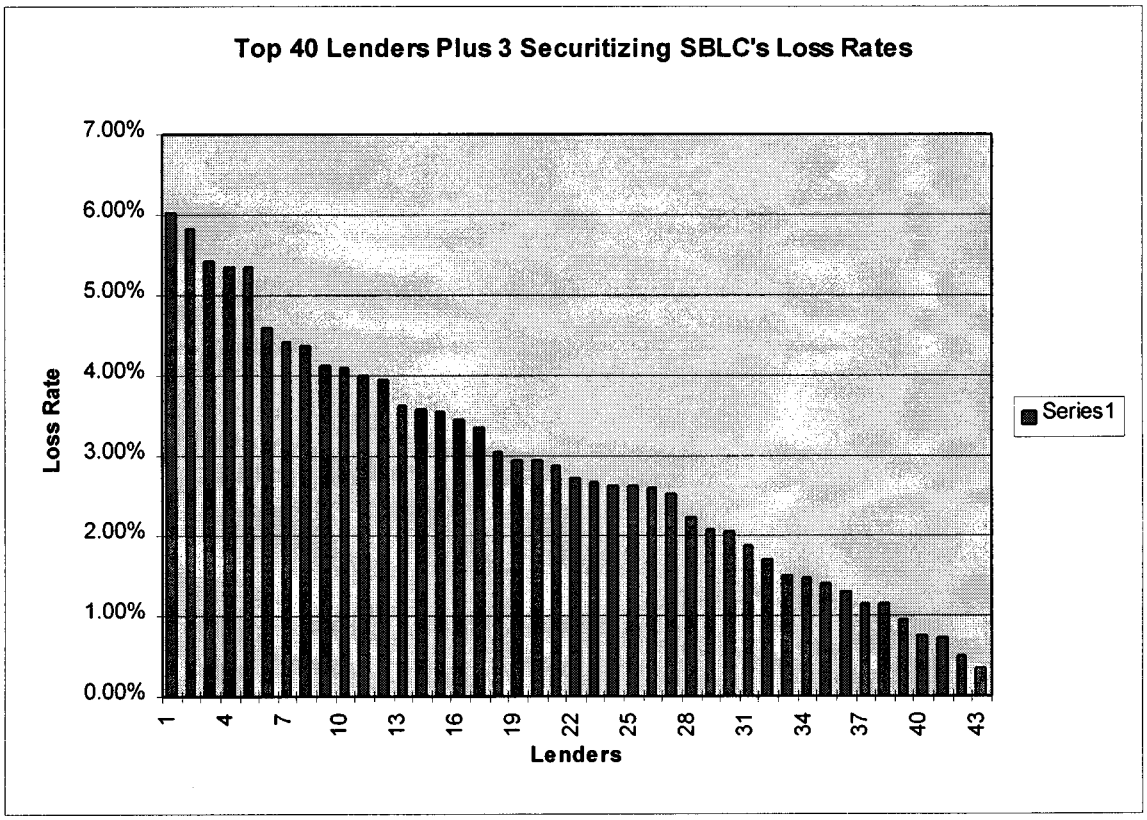
This proposed rule would apply to all securitizing nondepository institutions, including SBLCs, Business and Industrial Development Companies (''BIDCOs''), and other institutions approved for participation in SBA's loan programs. As the Federal agency with primary responsibility for regulating SBLCs, SBA has had a capital requirement for SBLCs in its regulations since 1975. SBA's capital requirements for SBLCs have not always been consistent with the capital requirements imposed by the bank regulatory agencies on depository institutions. For example, SBA's current SBLC regulations include a 10% capital requirement on the SBLC's share of all outstanding loans. At present, the capital requirement for depository institutions imposed by bank regulatory agencies applicable to comparable assets is 8%. Further, SBA's present capital requirement regulation does not consider the recourse issues associated with securitization already addressed by the bank regulatory agencies. SBA believes that conforming its capital requirements for securitizing SBLCs to general bank regulatory policy known and understood by the lending community would eliminate confusion and create a consistent and level playing field.

SBA currently requires SBLCs to maintain a minimum unencumbered paid in capital and paid in surplus equal to at least $1 million. SBA believes that a securitizing nondepository institution should have such minimum capital. Therefore, in addition to the requirements of bank regulatory agencies, SBA will require securitizing nondepository institutions to maintain such minimal capital. SBA also currently requires SBLCs to provide to SBA annual audited financial statements demonstrating that SBA's present capital requirement is met. The proposed rule would require all securitizing nondepository Lenders to submit such audited financial statements.

The Retention of a Subordinated Tranche

As proposed, SBA would require securitizers to retain a subordinated tranche equal to the greater of (a) twice the loss rate (the SBA charge off rate) experienced on a securitizer's SBA loans, originated or purchased, for a 10-year period or (b) 2% of the unguaranteed portion of the securitized loans. These securities would be subordinate to all other tranches issued. Based on historical data, SBA expects that most securitizers' retention levels would be between 12 and 2%. The current average would be 5.4% for SBA's high volume Lenders. (See the loss rates in Chart 1 below). It is a common practice for retention percentages to be based on multiples of expected losses. For example, rating agencies use a multiple of expected losses as part of the formula to determine the minimum amount a securitizer must deposit in the spread account. The 2% minimum approximates twice the cumulative loss rate of the best performing SBA loan originators. Currently, only four of the high volume Lenders referred to in Chart 1 would be below the 2% minimum threshold. Even for the best securitizers, SBA believes the minimum subordinated tranche is necessary to counter the potential risks of securitizing.

CHART 1



SBA is aware that a downturn in regional economic conditions may affect securitizers' loss rates adversely even though the securitizers' underwriting and servicing standards remain high. Under those circumstances, the rule would permit SBA to modify the formula for the retention size, if its enforcement might exacerbate the adverse economic conditions in the region.

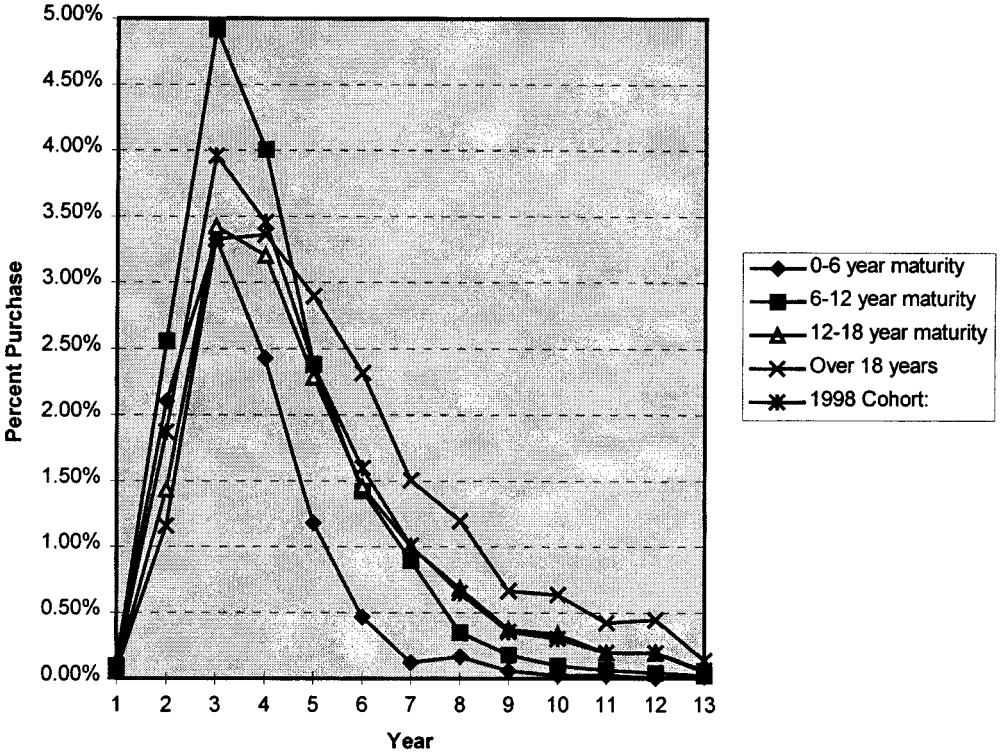
The retention requirement addresses SBA's concern that unusually large losses may occur early in the life of loans originated by a rapidly growing securitizer which may not be covered by Excess Spread or reflected in a securitizer's historical performance. SBA believes the proposed retention requirement is fair because there is a direct relationship between the size of the subordinated interest that a securitizer must retain and the securitizer's own historical performance. The proposed approach should give securitizers an added incentive to originate, purchase, and service high quality loans.

Under the proposed rule, securitizers would be able to sell the subordinated tranche at market value after retaining the tranche for six years. SBA's historical loss data indicates that its Lenders incur most losses between years three and five of a twenty-five year loan (see Charts 2 and 3). If the loans do not perform as expected, not only may the securitizer suffer losses, but the tranche will have significantly less value if the securitizer tries to sell it after the holding period ends. For this reason, requiring securitizers to hold the tranche for the six year period reinforces the incentive to originate and service high quality loans.

CHART 2
[In percent]

Defaults	Total	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7	Year 8	Year 9	Year 10	Year 11	Year 12	Year 13
0–6 year maturity	10.02	0.12	2.10	3.33	2.42	1.18	0.46	0.12	0.16	0.06	0.03	0.02	0.01	0.01
6–12 year maturity	17.02	0.09	2.56	4.92	4.00	2.38	1.42	0.89	0.35	0.18	0.10	0.06	0.04	0.03
12–18 year maturity	14.67	0.05	1.43	3.42	3.20	2.28	1.45	1.00	0.68	0.37	0.34	0.19	0.20	0.05
Over 18 years	18.11	0.05	1.16	3.32	3.36	2.89	2.32	1.50	1.19	0.66	0.64	0.42	0.45	0.14
1998 Cohort	16.11	0.08	1.87	3.96	3.46	2.37	1.60	1.01	0.65	0.35	0.30	0.20	0.20	0.07

Chart 3--Purchases of Defaulted Loans by Year



SBA selected a subordinated tranche as the retention level in its unified approach to regulating securitizations for several reasons. Unlike a retained pro-rata interest in the entire loan, or a cash reserve dedicated to SBA, a retained subordinated interest is a retained economic interest that benefits both SBA and investors. Several commenters and experts have suggested to SBA that such an interest is more sensitive to losses than other available options. The use of a subordinated tranche also is widely accepted by rating agencies and investors.

Unlike a menu of possible retainage options and combinations, retention of a subordinated tranche is a single, simple and uniform requirement. It introduces greater certainty to a developing market and makes it easier to compare one issue of securities with another. A cash reserve in SBA's control also would be less desirable to securitizers because such a reserve would earn less due to required conservative investing.

The size of the subordinated tranche is directly related to loan experience. The three options in SBA's proposed rule (62 FR 8640) of February 26, l997 established a set retention level equal to 5% of the entire loan, which is equal to 20% of the unguaranteed portion of a typical loan, without regard to credit quality or any measurable economic impact. SBA believes an empirically-based retention percentage is superior to a set 5% retention level because it reflects the credit quality and historical loan performance of the securitizer.

SBA has always required Lenders to maintain a meaningful economic interest in SBA guaranteed loans in order to protect the taxpayer. A number of past comments have suggested that SBA need not impose any retainage requirement because securitizers retained a sufficient continuing economic interest in the Excess Spread. These commenters argued that credit losses taken against the Excess Spread result in meaningful economic consequences to a securitizer that has recognized the present value of the future excess cash flow as income. SBA agrees with much of this argument. It acknowledges that the discipline and methodology imposed by, and the information generated by, the rating agencies provide valuable protection to SBA. Nevertheless, SBA has decided not to rely solely on rating agencies to set retention levels.

SBA believes that sole reliance on Excess Spread is not enough to protect taxpayers in the event of deteriorating loan performance. The market uses the Excess Spread to protect the investor, not the taxpayer. Some commenters and experts have asserted that reliance on securitization may change a securitizer's behavior and increase risk to the taxpayer. Since taxpayers have a greater dollar exposure on each loan than any investor, SBA believes it needs economic incentives in addition to those the market provides to ensure the safety and soundness of the 7(a) program.

Suspension of PLP Approval Privileges

For purposes of this proposed rule, if the currency rate of a PLP securitizer declines, SBA would suspend that securitizer's PLP approval privileges under two circumstances: (a) if the rate of decline is more than 110% of the rate of decline of the currency rate of all loans approved under the PLP program (PLP Program Loans) as calculated from quarter to quarter or (b) if the decline is more than five percentage points when the currency rate of the PLP Program Loans remains stable or increases. If the securitizer's currency rate remains stable or improves, the securitizer may continue to use PLP procedures for loan approval. SBA plans to calculate and compare the currency rate for PLP Program Loans and the currency rate for each securitizer's portfolio each quarter.

By suspending PLP approval privileges and requiring a Lender to submit all of its loans through SBA's field offices for approval, SBA can monitor a securitizer's credit practices more closely. Ideally, SBA will be able to identify declining loan performance before it can threaten a securitizer's entire portfolio and financial condition. SBA monitoring may assist the securitizer to improve credit practices while protecting the safety and soundness of the program. SBA may reactivate the securitizer's PLP approval privileges at any time.

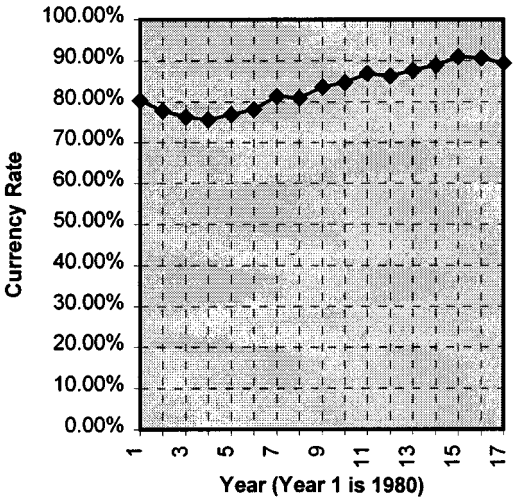
Based on an analysis of changes in the currency rate of the SBA portfolio over the past 16 years, SBA estimates that few securitizing PLP Lenders will be subject to the privilege suspension (see Charts 4 and 5). However, SBA recognizes that a downturn in the economy might trigger suspension for a greater number of PLP Lenders. Consequently, SBA has included in this rule a provision allowing SBA to waive suspension of PLP approval privileges for securitizers in an area where currency rates have been adversely affected by a downturn in regional economic conditions, if enforcing this element might exacerbate the adverse economic conditions in the area.

CHART 4

Year ending	Currency rate (percent)	Absolute value of change	Percentage change	110% of percent change
1980	80.20	.....	.....	.....
1981	77.70	0.0250	3.12	3.43
1982	76.20	0.0150	1.93	2.12
1983	75.50	0.0070	0.92	1.01
1984	76.80	0.0130	**1.72**	**1.89**
1985	78.00	0.0120	**1.56**	**1.72**
1986	81.30	0.0330	**4.23**	**4.65**
1987	80.90	0.0040	0.49	0.54
1988	83.50	0.0260	**3.21**	**3.54**
1989	84.70	0.0120	**1.44**	**1.58**
1990	86.90	0.0220	**2.60**	**2.86**
1991	86.20	0.0070	0.81	0.89
1992	87.60	0.0140	**1.62**	**1.79**
1993	88.80	0.0120	**1.37**	**1.51**
1994	90.90	0.0210	**2.36**	**2.60**
1995	90.60	0.0030	0.33	0.36
1996	89.40	0.0120	1.32	1.46
Average Change	.....	0.0149	.....	.....
Standard Dev	.....	0.0084	.....	.....

Cells in bold represent years when the currency rate increased, therefore the 5 percentage point test would apply.

Chart 5--Currency rate by year



SBA reviewed numerous methodologies to determine an equitable and effective way to measure a securitizer's credit quality and to establish a basis for comparison to overall portfolio behavior. SBA believes that currency rate is a reliable predictor of future losses. SBA also believes the thresholds it has selected are fair and would trigger economic consequences to the securitizer only if loan performance seriously declines.

Additional Levels

One of SBA's consultants proposed a fourth level to SBA's approach to regulating securitization which level would be based on a securitizer's loss rates and, therefore, be tied to long-term

performance. The consultant recommended that the fourth level be a supplemental payment. SBA would impose a supplemental payment equal to 1 percent of the outstanding balance of the securitization based on the performance of the loans in the securitization. If the securitization loss rate (1) remained the same, (2) declined, (3) increased by no more than 5 percent from year to year, or (4) was no more than 2 percent, than a supplemental payment would not be due. If, however, a securitization loss rate was over 2 percent and increased by more than 5 percent, the securitizer would be required to make a supplemental payment with respect to that securitization, if (a) the percentage change in the securitization loss rate was at least two times any percentage increase in SBA's loan portfolio loss rate or (b) the securitization loss rate is twice the loss rate of SBA's loan portfolio, and the loss rate for the SBA loan portfolio remained stable or declined. The provisions of this additional level would apply to a securitization only during the period the subordinated tranche would be required to be held. SBA would limit the supplemental payment to the holding period because it is during this crucial period that Lenders historically have experienced the highest loan losses.

Imposing an economic consequence if a securitizer's loan portfolio begins to show significant increases in losses would give a securitizer an additional direct financial incentive to maintain credit quality. Others with whom SBA has consulted agree that this would be an appropriate progression within SBA's regulatory approach. SBA is predisposed to add a fourth level featuring a direct financial incentive to its unified approach to securitization, but recognizes that it lacks legislative authority to impose new direct fees on its Lenders. SBA will be considering this matter further and welcomes comment on the subject.

In addition to the levels proposed, the rule would: a) require that SBA's Fiscal and Transfer Agent (''FTA'') hold all original promissory notes; (b) prohibit Lenders from securitizing loans not yet closed and fully disbursed; and (c) allow SBA to require all securitizers to use SBA's model multi-party agreement and model pooling and servicing agreement once developed. The use of the model agreements would expedite processing.

Multi-Lender Securitizations

Although SBA has not yet approved a multi-Lender securitization, it believes that low volume Lenders should have the same access to securitization as high volume Lenders. SBA expects that the market will develop the structures necessary to permit low volume Lenders to securitize. Several ideas are in the early stages of development. As part of this proposal, SBA is soliciting comments to assist it in formulating multi-Lender securitization requirements. What criteria should SBA use to review multi-Lender securitizations? Are there unique risks inherent in a multi-Lender transaction? Should all Lenders be eligible to participate in a multi-Lender transaction or should only Preferred Lender Program (''PLP'') Lenders be able to participate? Should each participant in the multi-Lender securitization be required to comply with the levels contained in this proposed rule? Does SBA need safeguards for multi-Lender securitizations in addition to those in this proposed role to ensure credit quality and loan performance and protect the safety and soundness of the 7(a) program?

II. Other Conveyances Component

The Other Conveyances component governs pledges and sales other than sales for the purpose of securitizing. This proposed rule would require SBA's prior written consent for the sale of a Lender's entire interest in a loan to another participating Lender. It would permit, with prior written notice to SBA, a sale after which the SBA Lender would continue to own a portion of the unguaranteed interest equal to at least 10% of the outstanding principal amount of the loan. This proposed rule would permit a Lender to sell an even greater portion of the loan as long as the sale received SBA's prior written consent, which consent could be withheld in SBA's sole discretion. The rules for sales of participating interests mirror those for sales. By allowing Lenders to sell the unguaranteed portion of their SBA loans in this manner, SBA encourages Lenders to make small business loans while protecting the safety and soundness of the 7(a) program.

Like the Interim Final Rule (62 FR 15601), this proposal also would require that a Lender obtain SBA's written consent prior to all pledges of SBA loans except for certain types of pledges enumerated in 13 CFR § 120.435. Except for such enumerated pledges, the SBA Lender must use proceeds of the loan secured by the SBA loans solely for the purpose of financing additional SBA loans. The provisions for pledging are almost unchanged from the Interim Final Rule.

Finally, this proposal incorporates several elements set forth in the Interim Final Rule and requires that a Lender be in good standing as determined by SBA. All documentation, including the multi-party agreement, must be satisfactory to SBA. The proposed rule also would require that a Lender or a third party acceptable to SBA hold the original promissory notes.

SBA seeks comments on all aspects of the proposal. In particular, SBA seeks comments suggesting any other level which it might incorporate in its unified regulatory approach as an additional incentive to securitizers to maintain high underwriting and servicing standards. For example, should additional action (beyond suspension of PLP approval privileges) be taken if a securitizer's loss rate declines significantly?

While this proposed rule is pending, SBA will continue to review proposed securitizations on a case by case basis under the Interim Final Rule.

Compliance With Executive Orders 12612, 12778, and 12866, the Regulatory Flexibility Act (5 U.S.C. 601, et seq.), and the Paperwork Reduction Act (44 U.S.C. Ch. 35)

SBA certifies that this proposed rule would not constitute a significant rule within the meaning of Executive Order 12866, since it is not likely to have an annual effect on the economy of $100 million or more, result in a major increase in costs or prices, or have a significant adverse effect on competition or the United States economy.

SBA certifies that this proposed rule would not have a significant economic impact on a substantial number of small entities within the meaning of the Regulatory Flexibility Act, 5 U.S.C. 601 *et seq.* This proposed rule is intended to replace SBA's Interim Final Rule published on April 2, 1997. Like the Interim Final Rule, it would allow depository Lenders to securitize loans (as nondepository Lenders have done for the last six years). Since the publication of SBA's Interim Final Rule almost one year ago, only one depository Lender has securitized. Moreover, that Lender would not qualify as small under SBA's size standards. 13 CFR § 121.201. SBA will consider any additional information from the public on its assessment of the impact of this proposed rule on small banks, nondepository institutions or other small businesses.

SBA certifies that this proposed rule would not impose any additional reporting or recordkeeping requirements under the Paperwork Reduction Act, 44 U.S.C. chapter 35.

For purposes of Executive Order 12612, SBA certifies that this proposed

rule would have no federalism implications warranting preparation of a Federalism Assessment.

For purposes of Executive Order 12778, SBA certifies that this proposed rule has been drafted, to the extent practicable, to accord with the standards set forth in section 2 of that Order.

List of Subjects 13 CFR Part 120

Loan programs—business, Reporting and recordkeeping requirement, Small businesses.

For the reasons set forth above, SBA proposes to amend 13 CFR part 120 as follows:

PART 120—[AMENDED]

1. The authority citation for 13 CFR Part 120 continues to read as follows:

Authority: 15 U.S.C. 634(b)(6) and 636(a) and (h).

2. Revise § 120.420 to read as follows:

Financings By Participating Lenders

§ 120.420 Definitions:

Bank regulatory agencies—The bank regulatory agencies are the Federal Deposit Insurance Corporation, the Federal Reserve Board, the Office of the Comptroller of the Currency, and the Office of Thrift Supervision.

Currency rate—A securitizer's ''currency rate'' is the dollar balance of its SBA guaranteed loans that are less than 30 days past due divided by the dollar balance of its outstanding portfolio of SBA guaranteed loans, as calculated by SBA.

Good standing—A securitizer is in ''good standing'' with SBA if it is in compliance with all applicable laws and regulations, policies and procedures, is in good financial condition as determined by SBA, and is not under investigation, indictment for, has not been convicted for or had a judgment entered against it or have any officers or employees who have been convicted, indicted, under investigation or the subject of a civil judgment for a felony or charges relating to a breach of trust or violation of a law or regulations protecting the integrity of business transactions or relationships.

Loss rate—A securitizer's ''loss rate'', as calculated by SBA, is the aggregate principal amount of the securitizer's SBA guaranteed loans determined uncollectable by SBA for the most recent ten year period, excluding current fiscal year activity, divided by the aggregate original principal amount of SBA guaranteed loans disbursed by the securitizer during that period.

Nondepository institution—A ''nondepository institution'' is a Small Business Lending Company regulated by SBA (''SBLC'') or a Business and Industrial Development Company (''BIDCO'') or other nondepository institution participating in SBA's 7(a) program.

Securitization—A ''securitization'' is the pooling and sale of the unguaranteed portion of SBA guaranteed loans to a trust, special purpose vehicle, or other mechanism, and the issuance of securities backed by those loans to investors in either a private placement or public offering.

3. Add § 120.421 through 120.428 to read as follows:

§ 120.421 Which Lenders may securitize?

All SBA participating Lenders may securitize.

§ 120.422 Are all securitizations subject to these regulations?

All securitizations are subject to the regulations in this part. SBA will consider securitizations involving multiple Lenders on a case by case basis. SBA will use the conditions in § 120.425 as a starting point for reviewing multiple Lender securitizations. Securitizations by affiliates are considered single Lender securitizations for purposes of the regulations in this part.

§ 120.423 Which SBA loans may a Lender securitize?

Notwithstanding the provisions of § 120.453(c), a Lender may only securitize guaranteed loans that are fully disbursed by the closing date of the securitization. If the amount of a fully disbursed loan increases after a securitization settles, the Lender must retain the increased amount.

§ 120.424 What are the basic conditions a Lender must meet to securitize?

To securitize, a Lender must:

(a) Be in good standing as determined by the Associate Administrator for Financial Assistance (AA/FA);

(b) Use a securitization structure which is satisfactory to SBA;

(c) Use documents acceptable to SBA, including SBA's model multi-party agreement;

(d) Obtain SBA's written consent, which it may withhold in its sole discretion, prior to executing a commitment to securitize; and

(e) Cause the original notes to be stored at the FTA, as defined in § 120.600, and other loan documents to be stored with a third party approved by SBA.

§ 120.425 What are the minimum elements that SBA will require before consenting to a securitization?

A securitizer must comply with the following three conditions:

(a) Capital requirement.—All securitizers must maintain minimum capital consistent with the requirements imposed on depository Lenders by the bank regulatory agencies. For depository institutions, SBA will consider compliance with the capital requirements of the bank regulatory agencies as compliance with this section. SBA's capital requirement does not change that which these banking agencies already require. In addition to meeting the capital requirements of the bank regulatory agencies, securitizing nondepository institutions also must maintain a minimum unencumbered paid in capital and paid in surplus equal to at least $1 million. Each nondepository institution must submit annually audited financial statements demonstrating that it has met SBA's capital requirement.

(b) Subordinated tranche.—A securitizer must retain a tranche of the securities issued in the securitization (subordinated tranche) equal to the greater of two times the securitizer's loss rate on the securitizer's SBA loans, original and purchased, for a 10 year period or 2 percent of the outstanding principal balance at the time of securitization of the unguaranteed portions of the loans in the securitization. This tranche must be subordinate to all other securities issued in the securitization including other subordinated tranches. The securitizer may not sell, pledge, transfer, assign, sell participations in, or otherwise convey the subordinated tranche during the first 6 years after the date of closing of the securitization. The securities evidencing the subordinated tranche must bear a legend stating that the securities may not be sold until 6 years after the issue date. SBA may modify the formula for determining the tranche size for a securitizer in a region affected by a severe economic downturn if it concludes that enforcing this section might exacerbate the adverse economic conditions in the region.

(c) PLP privilege suspension.—(1) If a PLP securitizer's currency rate declines, SBA may suspend the securitizer's PLP unilateral loan approval privileges (PLP approval privileges) under either of the following circumstances:

(i) If the decline is more than 110% of the rate of the decline of the currency rate of all loans approved under the PLP program (PLP Program Loans) as calculated from quarter to quarter or

(ii) If the decline is more than five percentage points and the currency rate of the PLP Program Loans remains stable or increases.

(2) SBA will calculate and compare the currency rate for PLP Program Loans and the currency rate for each securitizer's portfolio each quarter. Loans approved in the current fiscal year will not be included in the calculation of the currency rate. In the event of a severe downturn in a regional economy, a securitizer's currency rate is adversely affected, SBA may waive privilege suspension for all securitizers in the region, if it concludes that enforcing this section might exacerbate the adverse economic conditions in the region.

§ 120.426 What action will SBA take if a securitizer transfers the subordinated tranche prior to the termination of the holding period?

If a securitizer transfers the subordinated tranche prior to the termination of the holding period, SBA immediately will suspend the securitizer's ability to make new SBA loans. The securitizer will have 30 calendar days to submit an explanation to SBA. SBA will have 30 calendar days to review the explanation and determine whether or not to lift the suspension. If an explanation is not received within 30 calendar days or the explanation is not satisfactory to SBA, SBA may transfer the servicing of the applicable securitized loans, including the securitizers' servicing fee on the guaranteed and unguaranteed portions and the premium protection fee on the guaranteed portion, to another SBA participating Lender.

§ 120.427 Will SBA approve a securitization application from a capital impaired Lender?

If a Lender does not maintain the level of capital required by § 120.425(a), SBA will not approve a securitization application from that Lender.

§ 120.428 What happens if SBA suspends a securitizer's PLP approval privileges?

If SBA suspends a securitizer's PLP approval privileges:

(a) the securitizer must continue to service and liquidate loans according to its PLP Supplemental Agreement.

(b) SBA may reinstate the securitizer's PLP approval privileges if the securitizer demonstrates to SBA's satisfaction that the change in currency rate was caused by factors beyond the securitizer's control.

4. Redesignate current § 120.430 as § 120.414.

5. Redesignate current § 120.431 as § 120.415.

6. Add §§ 120.430 through 120.435 to read as follows:

Other Conveyances

§ 120.430 What conveyances are covered by §§ 120–430 through 120.435?

Sections 120.430 through 120.435 cover all other transactions in which a Lender sells, sells a participating interests in, or pledges an SBA guaranteed loan other than for the purpose of securitizing and other than conveyances covered under subpart F of this part.

§ 120.431 Which Lenders may sell, sell participations in, or pledge SBA loans?

Notwithstanding the provisions of Section 120.453(c), all Lenders may sell, sell participations in, or pledge SBA loans in accordance with this subpart.

§ 120.432 Under what circumstances does this rule permit sales of, or sales of participating interests in, SBA loans?

(a) A Lender may sell all of its interest in an SBA loan to another Lender operating under a current Loan Guarantee Agreement (SBA Form 750) with SBA's prior written consent, which SBA may withhold in its sole discretion. The purchasing Lender must take possession of the promissory note and other loan documents and service the sold SBA loan. The purchasing Lender must sign an agreement satisfactory to SBA acknowledging that it is purchasing the loan subject to SBA's right to deny liability on its guarantee.

(b) A Lender may sell, or sell a participating interest in, a part of an SBA loan. If the Lender retains ownership of a part of the unguaranteed portion of the loan equal to at least 10% of the outstanding principal balance of the loan, the Lender must give SBA prior written notice of the transaction, and the Lender must continue to hold the note and service the loan. If a Lender retains ownership of a portion of the unguaranteed interest of the loan equal to less than 10% of the outstanding principal balance of the loan, the Lender must obtain SBA's prior written consent to the transaction, which consent SBA may withhold in its sole discretion. The Lender must continue to hold the note and service the loan unless otherwise agreed by SBA.

(c) For purposes of this section SBA will not consider a Lender to be the owner of any portion of a loan in which it has sold a participating interest.

§ 120.433 What are SBA's other requirements for sales and sales of participating interests?

SBA requires the following:

(a) The Lender must be in good standing as determined by the AA/FA;

(b) In transactions requiring SBA's consent, all documentation must be satisfactory to SBA, including, if SBA determines it to be necessary, a multi-party agreement or other agreements satisfactory to SBA; and

(c) The servicer of the loan or FTA must retain possession of the original promissory notes. The servicer must retain possession of all other original loan documents for all loans.

§ 120.434 What are SBA's requirements for loan pledges?

(a) Except as set forth in Section 120.435, SBA must give its prior written consent to all pledges of any portion of an SBA loan, which consent SBA may withhold in its sole discretion;

(b) The Lender must be in good standing as determined by the AA/FA;

(c) All loan documents must be satisfactory to SBA and must include a multi-party agreement among SBA, Lender, the pledgee, FTA and such other parties as SBA determines are necessary;

(d) The Lender must use the proceeds of the loan secured by the SBA loans only for financing SBA loans;

(e) The Lender must remain the servicer of the loans and retain possession of all loan documents other than the original promissory notes; and

(f) The Lender must transfer the original promissory notes to FTA.

§ 120.435 Which loan pledges do not require notice to or consent by SBA?

The following pledges of SBA loans do not require notice to or consent by SBA:

(a) Treasury tax and loan accounts;

(b) The deposit of public funds;

(c) Uninvested trust funds;

(d) Discount borrowings at a Federal Reserve Bank; or

(e) Pledges to the Federal Home Loan Bank Board.

Dated: May 5, 1998.

Aida Alvarez,

Administrator.

[FR Doc. 98–12535 Filed 5–15–98; 8:45 am]

BILLING CODE 8025–01–P