

STATEMENT  
OF  
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BEFORE THE  
SUBCOMMITTEE ON ECONOMIC GROWTH  
AND CREDIT FORMATION  
COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS  
OF THE  
U.S. HOUSE OF REPRESENTATIVE

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Rayburn House office Building

Chairman Kanjorski, Committee members, I appreciate the opportunity to appear before you and to discuss securitization of small business loans. My name is Tamar Frankel. I am a Professor of Law at Boston University School of Law in Boston, Massachusetts. Broadly, my interest is in the regulation of financial institutions and markets: those who manage other peoples' money. I have taught and wrote on fiduciary law generally, and on securities regulation, insurance and pension regulation. Among my publications are two treatises. One is a 1978 treatise on the Regulation of Money Managers that deals with the regulation of mutual funds and investment advisers. The other is a 1991 treatise on Securitization of loans. (A more detailed resume is attached to this statement.)

During the 1970's credit crunch, securitization helped Americans obtain mortgage loans to acquire homes. The question that we are addressing today is whether securitization can help small and medium size commercial businesses finance their businesses. Can we, by securitizing business loans, increase funding for small and medium size businesses? (I use the term "businesses" or "small businesses" to include medium size businesses). Let me list a number of questions involving this important issue.

1. Is there a "credit crunch" for small businesses?
2. If yes, what are the reasons for this "credit crunch"?
3. Can securitization help open the door to small business financing?
4. If securitization of small business loans is possible, why is it not done today?
5. How can we lower the cost of originating, standardizing the loan terms, and enhancing the credit for small business loans? How can we use statistics to design prototype profiles of small businesses to determine the rate of riskiness of various businesses?
6. How can securitization of business loans be enhanced through amendments of existing law?
7. What is the market doing to bring about securitization of business loans?
8. Where the market fails, who should help in the securitization process?

I will speak shortly to each of these points.

1. Is there a "credit crunch" for small businesses? Is it currently the case that even businesses that are good credit risks cannot receive loans at all, or cannot obtain loans at comparative rates?

There are those who argue that there is no "credit crunch" for small businesses nation-wide, and that in parts of the country banks are seeking small business loans. That may, indeed, be so. It is clear, however, that in parts of the country, such as the Northeast, small businesses, including businesses with good credit, are hurting for lack of financing.

There are those who argue that securitizing small business loans will not help the borrowers. Loans of risky borrowers are not competitive. Investors will demand, and small business borrowers will pay, higher than average interest on their loans.

I, for one, do not believe that markets in small loans are so efficient. Not all small business loans in the Northeast are risky. When businesses with good credit cannot get bank loans at competitive rates, perhaps something is wrong with the system, as was wrong with the mortgage loan markets in the 1970's. Therefore, I believe that there is a credit crunch for small businesses.

2. What are the reasons for the "credit crunch?" Let me list a number of possible reasons:

- (i) in some areas banks may not have the funds to lend to small business;
- (ii) banks may refuse to lend to small businesses in depressed areas because all businesses there are presumed risky;
- (iii) banks may have available to them alternative competing investments that are less risky and bring higher income than business loans. Small business borrowers may be unable to compete with alternative investments because information costs about these business loans have increased with bank restructuring. Small banks with long-term roots in the community had accumulated vast information about the members of the community. Loan officers of these banks could easily distinguish between good and bad credit. As these banks are acquired by larger banks, loan decisions are centralized, and this reservoir of information was lost. In addition, to reduce costs, loan officers seek larger loans. Furthermore, loan officers no longer provide small businesses with financial advice and guidance, as in the past. In short, centralized loan decision making has eliminated the personal and advisory relationship between loan officers and bank borrowers.
- (iv) it may well be that banks are deterred from making loans to small businesses because of the capital requirement. For most business loans capital requirement is very high (100%). If these loans cannot be sold at a competitive price, a bank that needs to raise capital will be better off making or acquiring loans that can be securitized and for which a secondary market exists.

In short, business loans today suffer from a double disadvantage. These business loans have become less attractive to originators. At the same time other loans (e.g. mortgages) have become more attractive to originators and investors, and therefore

less costly to those borrowers.

3. Can securitization help open the door to small business financing? I believe that, under certain conditions, a secondary market for business loans can alleviate the tight credit for small businesses and provide them with loans at competitive rates. But that secondary market will arise only if we find ways to reduce the risks of these loans to investors.

To reduce the risk to investors the cash flow from a pool of these loans must be more predictable. To render the cash flow more predictable, we must reduce the information costs about small business loans (both on the borrowers and the collateral, if any); standardize the terms of these loans; rate the securities issued by the pools of these loans; and provide some guarantees to reduce investors' risks.

4. If securitization of small business loans is possible, why is it not done today? There are a number of answers to this question:

- (i) we lack data about the behavior of small business loans because before the computer age, banks did not maintain data bases about their loans;
- (ii) information about small business loans is not pooled, and the terms of these loans are not standardized. With 14,000 banks, neither information nor in-house standardization spill over to other banks. There are no profiles of small business available today. Since few banks have very large small business loan portfolios, banks that make these loans do not have the data or know-how and equipment to create a database from which to derive the criteria for evaluating such loans.
- (iii) unlike the insurance regulators, bank regulators did not develop techniques for evaluating credit risks related to bank loan portfolios. To this very day, the regulators and the banks (to a great extent) focus on evaluating single bank loans. The reason for the different regulatory techniques may be that bank regulators seek to avoid affecting capital allocation by assigning risks to economic sectors (by business or size).
- (iv) the development of criteria and standards for small business loans involves substantial investments. If these investments become public goods, the criteria will not be developed by the private sector "public goods". We cannot expect the private sector to share the criteria with competitors without compensation. In addition, information on which the criteria are based may be confidential, although there are ways to overcome this problem.

5. How can we lower costs of originating and standardizing the loan terms, and enhancing the credit of small business loans? How can we use statistics to design prototype profiles of small businesses to determine their level of riskiness?

The variety of small businesses is great, indeed, but I have been told that, with appropriate data, it is possible to establish prototype profiles of small businesses and criteria to evaluate the risks involved in lending to them. Like insurance risk criteria, we can create risk criteria for particular types of businesses (and assets that they hold) under particular conditions.

The legislature can encourage the creation and maintenance (and perhaps require reporting) of such data by banks, other lenders, debt collectors, and the Small Business Administration, among others. Credit agencies that rate individuals can also help reduce the cost of evaluating small businesses, since such businesses usually borrow with recourse to their owners.

6. How can securitization of business loans be enhanced through amendments of existing law?

There are a number of laws that should be examined in light of the nature of business loan pools: the Investment Company Act of 1940; tax laws to grant small business loan pools pass-through tax treatment. In addition, the legal status of transferred assets to the pools may have to be clarified under the Uniform Commercial Code and the Bankruptcy Code. For example, when assets are sold to a pool, and the assets include notes, compliance with the requirements of the Uniform Commercial Code to render the pool holder in due course may be too costly (e.g. endorsing thousands of notes). Notice of the transfer to the creditors of the transferror that continues to service them is also problematic, especially when the transferror fails. Congress addressed this problem in section 541(d) of the Bankruptcy Code. Perhaps pools of other types of assets should receive the same treatment. Another issue that should be clarified is the status the seller of loans if he continues to hold subordinated securities issued by the pool of assets that he had sold. The holding of such securities by the seller offers credit enhancement and reduces the cost of securitization. However, sellers may refrain from holding the securities if the holding is deemed recourse to the seller, in which case the sale is not recognized by regulators and the seller could not improve its capital by removing the sold loans from its assets.

We may consider providing incentives for another form of enhancement. It is less costly to securitize loans made to acquire specific assets, and loans backed by specific assets, such as receivables or notes of customers with good credit. Loans used for working capital (which may be the most needed today) are harder to evaluate and securitize. If a bank makes loans backed by assets for the purpose of securitizing the loans, and at the same time makes

loans for working capital to the same borrower, the bank is in a better position to monitor and enforce the loans. Since the lending bank usually holds the borrowers' deposits, they provide additional security for the loan and information about the borrower's business. Banks should be given incentives to make small business loans for securitization and loans for working capital (for holding) because such banks serve as reliable originators of business loans. The dual loans and retention of the working capital portion may render the other parts easier to securitize.

7. What is the market doing to encourage the securitization of business loans?

Originators, rating agencies and the sellers of securitized loans are currently working on reducing the origination costs and on developing evaluation criteria for small businesses. Their efforts should be encouraged. I understand that regional banks are moving towards reducing the information costs of small business loans. These banks have adopted a strategy to reverse the trend of centralizing loan making. They decentralize the loan decision making, vesting the power at the community level. This structure enables the bank to recapture and maintain the information about businesses as well as the personal advisory relationships with their borrowers.

8. Where the market fails, who should help in the securitization process? If the government is to play a role, what should it be?

Recent history shows that the first and most risky stage in securitization was developed and underwritten by the government. The private sector followed rather than led the process. If the policy to support loans to small businesses is similar to the policy to support mortgage loans, then it is necessary for the government to get involved in securitizing these loans.

The government may help create, sponsor or encourage the creation of a "credit information agency" to gather data on small businesses, establish risk criteria, and standardize the terms of small business loans.

The government could intermediate small business loans, buying the loans and selling them with guarantees (of the loans by the full faith and credit of the United States government, or a government agency, such as FNMA). Through these activities the government may create the necessary database and lending criteria and the standardized terms and underwriting standards for these loans. As more information about the loans will be available the required guarantees will become lower.

Which government agency or corporation could best serve these functions? One possibility is to establish a special government agency similar to FNMA or Freddie Mac for small business loans.

This solution may not be the most economic. An alternative is to expand the mandate of existing government agencies that are expert in securitizing other types of loans (e.g. FNMA). However, these agencies may have little information and experience about securitizing small business loans. A third possibility is to vest the Small Business Administration (SBA), the Federal Deposit Insurance Corporation (FDIC) and the Resolution Trust Corporation (RTC), together or separately, with the mandate to securitize small loans. These agencies have data on how small business loans fare and expertise in selling these loans. The SBA has developed criteria for guaranteeing such loans and programs for securitizing their guaranteed portions. The FDIC and the RTC have vast amount of information about small business loans and are engaged in securitizing loans (performing and non-performing).

In addition, the FDIC has regulatory powers. It can require banks to report the data from which the underwriting criteria for small business loans can be created. It can give banks the choice, incentives or require them to follow these criteria, and to standardize their small business loans. All these agencies could cooperate among themselves and with rating agencies and others to create the infrastructure for securitizing small business loans.

Securitization is not a magic formula for creating credit. It has adverse side-effects. For example, securitization will benefit borrowers by making credit at competitive rate available. However, securitization requires inflexible loan terms to render the cash flow predictable and borrowers seeking different loan terms might have to pay higher interest. Securitization may offer banks many advantages but it also exposes the banks to far greater competition.

Notwithstanding these disadvantages I believe that unless small businesses receive bank credit soon, Congress should move to help small businesses obtain affordable financing by alternative means such as securitization. Thank you.

RESUME

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PUBLICATIONS:Books

Securitization: Structured Financing, Financial Assets Pools, and Asset-Backed Securities (a two-volume treatise) (Little, Brown & Company 1991).

The Regulation of Money Managers (Investment Company Act and Investment Advisers Act) (a four-volume treatise) (Little, Brown & Company 1978, 1980).

Book Chapters

Securitization: Its Effect On Bank Structure, in Structural Change In Banking 309 (Michael Klausner & Lawrence J. White eds. N.Y.U. Salomon Center, Leonard N. Stern School of Business 1993)

Decision Making for Social Investing, in Social Investing 131 (Dan McGill ed. for Pension Research Council, Wharton School, Univ. of Pennsylvania, Richard D. Irwin, Inc. 1984) (regulation of pension funds' investments).

Bank Loan Participations under the Securities Acts; The Implications of SIA v. Board of Governors (Becker), in 16th Annual Institute of Securities Regulation Vol. 2 at 311 (PLI 1984) (bank loans and the securities markets regulation).

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#### Newspaper Articles

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'Carrots' Should be Utilized by Bank Regulation, Legal Times, January 13, 1986.

The Problem of Off-Balance-Sheet Liabilities, American Banker, December 12, 1985.

Deposit Insurance and Risk: A Shaky Connection, American Banker, August 1, 1985.

#### LEGAL BACKGROUND:

Jan. 1986- Aug. 1987	Guest Scholar, The Brookings Institution, Washington D.C.
Aug. 1985	Faculty, Graduate School of Banking, Madison, Wisconsin
1983-1985	Consultant to Bankers Trust Co., New York
1982-1983	Visiting Professor of Law, University of California Law School, Berkeley, California
1980-(Fall Semester)	Visiting Professor of Business Management, Harvard Business School (course: Law and the Corporate Manager)
1979-1980	Visiting Professor of Law, Harvard Law School
1971-Present	Professor of Law, Boston University School of Law
1968-1970	Assistant Professor of Law, Boston University School of Law
1967-(Fall Semester)	Lecturer, Boston University School of Law
1966-1967	Special Assistant to the Commissioner of Corporations, State of California
1965-1966	Associate, Arnold & Porter, Washington, D.C.

1964-1965 Associate (part-time), Ropes & Gray, Boston, Massachusetts

1962-1963 Legal Advisor, State of Israel Bonds Organization, Europe, Rue Lafitte, Paris, France

1951-1962 Private Practice, Tel Aviv, Israel

1949-1950 Assistant Attorney General, State of Israel, Ministry of Justice, Legislation Department

1948-1950 Assistant Legal Advisor, Israeli Air Force

EDUCATIONAL  
BACKGROUND:

1972 S.J.D., Harvard Law School

1965 LL.M., Harvard Law School

1962 Qualifying for Ph.D. in Law, Hebrew University Law School, Jerusalem, Israel

1943-1947 Jerusalem Law Classes, Jerusalem, Israel, Diploma Date -- April 26, 1948

COURSES TAUGHT:

Corporations, The Regulation of Financial Institutions, Securities Regulation, Insurance, Partnerships and Closed Corporations, Trusts and Estates, Fiduciary Law (Seminar), Mutual Funds (Seminar), Employee Benefit Plans (Seminar).

BAR AND PROFESSIONAL  
ASSOCIATION

MEMBERSHIPS:

Massachusetts Bar Association; Israeli Bar (limited); Boston Bar Association; American Bar Association, Section of Corporate, Banking and Business Law, Committee on Federal Regulation of Securities; Banking Committee; American Law Institute.

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