SMA

13 CFR Part 120

RIN 3245-AH29

Secondary Market Program – Proposed Regulatory Changes

AGENCY: U.S. Small Business Administration.

ACTION: Advance notice of proposed rulemaking.

SUMMARY: The U.S. Small Business Administration (SBA or Agency) is considering a change in the structure of its secondary market 7(a) loan pool security to better align the collateral and cash flows to support the long-term viability of the SBA secondary market 7(a) loan pooling program. Specifically, SBA seeks public comment on the alignment of cash flows between the collateral (the guaranteed portion of 7(a) loans) and the pool security (Pool Certificate), the timely payment of scheduled interest and actual principal, and the publication of additional loan-level disclosure. The Agency is also seeking public comment on registering such securities in book-entry form.

DATES: Comments must be received on or before [INSERT DATE 60 DAYS AFTER PUBLICATION IN THE FEDERAL REGISTER].

ADDRESSES: You may submit comments, identified by RIN 3245-AH29, by any of the following methods:

- Federal eRulemaking Portal: https://www.regulations.gov. Follow the instructions for submitting comments.
- Mail/Hand Delivery/Courier: Peter Meyers, Office of Capital Access, U.S. Small Business Administration, 409 Third Street, S.W., 8th Floor, Washington, D.C. 20416.

All comments will be posted on https://www.regulations.gov. If you wish to submit confidential business information (CBI) as defined in the User Notice at https://www.regulations.gov, you must submit such information either by mail to Peter

Meyers, Office of Capital Access, U.S. Small Business Administration, 409 Third Street S.W., 8th Floor, Washington, D.C. 20416, or by email to Peter.Meyers@sba.gov. Highlight the information that you consider to be CBI and explain why you believe SBA should hold this information as confidential. SBA will review your information and determine whether it will make the information public.

FOR FURTHER INFORMATION CONTACT: Peter Meyers, Office of Capital Access, U.S. Small Business Administration, 409 Third Street S.W., 8th Floor, Washington, D.C. 20416; (202) 527-1253 or Peter.Meyers@sba.gov.

SUPPLEMENTARY INFORMATION:

I. Background

The Secondary Markets Improvement Act of 1984 (Pub. L. 98–352) authorized SBA to establish a secondary market to facilitate the pooling of the guaranteed portion of 7(a) loans (underlying loans) into securities (referred to as Pool Certificates). The SBA secondary market allows SBA Lenders to expand their commitment to small businesses by establishing a process for the sale and pooling of SBA-guaranteed 7(a) loans into securities, which enables SBA Lenders to leverage their capital and make more 7(a) loans. SBA Lenders may sell SBA-guaranteed 7(a) loans to SBA-approved Pool Assemblers, who aggregate loans into SBA pools (the underlying loans represent the collateral for the pool). SBA then issues Pool Certificates representing ownership of all or a fractional undivided interest in a part of those pools. SBA's guarantee on Pool Certificates is backed by the full faith and credit of the United States.

Currently, investors receive a timely payment guarantee of principal and interest on Pool Certificates. However, certain structural limitations of the current pool security prevent the instrument from performing like a pure pass-through security. For example, mismatches in cashflows between the underlying loan collateral and the pool security may result in the accumulation of amortization excess in SBA's Master Reserve Fund

("MRF"). Historically, the program costs associated with amortization excess (and the additional coupon interest paid while the amortization excess remains in the MRF) has been absorbed by SBA.

Other U.S. government-backed securities issued by government-sponsored enterprises pass through all prepayments to the security holder, which keeps the cash flow from the underlying loan collateral aligned with the cash flow paid on the related securities. Government-sponsored enterprises also disclose a significant amount of loan-level information which provides investors with a better understanding of underlying loan collateral performance and may enhance more accurate security pricing.

II. Current SBA Secondary Market 7(a) Loan Pool Security

SBA's current secondary market 7(a) loan pool security provides for the timely payment of principal and interest each month. Full prepayments from the underlying loans are passed through to the Pool Certificate holders. Partial prepayments greater than 20% of the outstanding principal balance of the loan at the time of prepayment are also passed through to the Pool Certificate holders. However, partial prepayments that are 20% or less than the outstanding principal balance of the loan at the time of prepayment are held in the MRF for future distribution. While this current structure may protect the Pool Certificate holder from some prepayment risk, it can create imbalances between the underlying loans in the pool and the balance outstanding on the related Pool Certificates. SBA is seeking to eliminate this imbalance through the creation of a new SBA secondary market 7(a) loan pool security that better aligns payments in with payments out. SBA anticipates that the proposed solution will reduce the risk assumed by SBA for administering the 7(a) loan pooling program.

SBA believes that offering a 7(a) loan pool security that is more similar to those of other government-backed enterprises will provide more consistent long-term stability for pool security payments, which will attract more institutional investors. SBA also believes that these changes will promote a continued source of liquidity for SBA Lenders that make 7(a) loans to small businesses.

III. Proposed New SBA Secondary Market 7(a) Loan Pool Security

A. Alignment of Cash Flows

SBA is considering the issuance of a new modified pass-through pool security that would better align the actual monthly cash flows of the underlying loans with the pool security. The underlying loans are structured as simple interest term loans that are amortized over their respective loan maturities. The allocation of principal and interest on any given installment payment is dependent on when the payment is received relative to when it is due. Accrued interest is paid up to the date of receipt of payment, with all remaining amounts applied to principal. When the underlying loans are paid as agreed according to their loan terms, the scheduled principal received from borrowers aligns with their respective loan amortization schedules. However, when borrower payments are late or missed, the payment of all accrued interest must be satisfied first before any remaining amount is applied to the principal outstanding. This can result in reduced loan principal paid by the borrower and, in some instances, no payment of principal at all. SBA does not require SBA Lenders, as loan servicers, to advance principal payments to make up for these differences. Under this current structure, the risk to SBA of supporting a scheduled principal payment to Pool Certificate holders is not sustainable over the long-term.

The current SBA secondary market 7(a) loan pool security is further complicated by underlying loan prepayments. Scheduled pool principal is paid to Pool Certificate holders based on the outstanding pool principal balance and the remaining months to maturity of the pool. This can create a difference between the remaining pool principal balance outstanding and the principal balance outstanding on the underlying loans. Full prepayments (which include voluntary prepayments by borrowers and involuntary prepayments resulting from SBA's payment on its guarantee on defaulted 7(a) loans) require a reconciliation of the allocated principal paid to the pool compared with the actual loan principal received from the underlying loans. This reconciliation may result in a reduced amount of prepayment principal paid to Pool Certificate holders because portions of prepayment principal may be needed to cover a shortfall of principal collected on a specific loan. Conversely, this reconciliation may result in an additional amount of prepayment principal paid to Pool Certificate holders due to actual loan principal previously collected on a specific loan but not yet distributed.

B. Timely Payment of Scheduled Interest and Actual Principal

As a solution to the misalignment of cash flows noted above, SBA is proposing to restructure its 7(a) loan pool security to provide for the timely payment of *scheduled* interest and *actual* principal received. SBA believes that this form of a modified pass-through security would remove differences arising from scheduled principal paid and actual principal received and eliminate the reconciliation and adjustment exercise occurring on all principal prepayments. Scheduled interest will be calculated using a 30/360 accrual method (i.e., interest will be calculated on the basis of a 360-day year consisting of twelve 30-day months). It is a much simpler form of security and allows investors to monitor pool prepayment speeds based on the actual prepayment activity of the underlying loans. SBA believes that this will provide greater transparency to market participants.

This structural change in the pool security will bring SBA Pool Certificates more in line with other U.S. government-backed securities and may be more marketable to potential investors. SBA believes that passing all prepayments through to the Pool Certificate holder will promote greater predictability of monthly cash flows This will keep the underlying loan balances in sync with the related Pool Certificate balances and will no longer require the MRF to retain amortization excess or make advances of pool principal.

Implementing a more standardized set of pool characteristics, such as requiring the same underlying loan payment due date and requiring ACH debits on underlying loan payments will also simplify the pooling process and create a more viable program for the long-term

C. Loan-Level Disclosure

In addition to the new features described above, SBA is considering a robust set of loan-level disclosures to accompany the launch of a new pass-through security. This data will provide investors with greater insight on the underlying loans and may help inform more accurate pricing decisions. A new disclosure portal could be launched to provide historical and current loan-level data as well as customizable reports.

D. Book Entry Registration

To further align a new pool security with other U.S. government-backed securities, SBA is proposing a book-entry form of registration. This electronic record of ownership will allow the pool security to be traded or transferred with greater ease than a physical certificate.

IV. Request for Comment

SBA requests comments from the public on the questions listed below. The list of questions is meant to assist in the formulation of public comments and is not intended to restrict the issues that may be addressed. Responders are invited to comment on any or all portions of this ANPRM.

A. Questions About the Alignment of Cash Flows

1. What are the advantages or disadvantages to SBA revising the current method of administering loan prepayments and other unscheduled principal payments?

2. Are there benefits of knowing that a pool's underlying loan collateral balance will be in sync with that pool's outstanding security balance?

3. What impact would this proposed new security have on the SBA secondary market 7(a) loan pooling program?

4. What effect would the alignment of cash flows have on the pricing of a security?

B. Questions About the Timely Payment of Scheduled Interest and Actual Principal

1. What payment features are most important when considering a new pool security? Are there certain payment features of the current Pool Certificate that SBA should consider changing?

2. What effect would the timely payment of scheduled interest and actual principal have on the pricing of a pool security?

C. Questions About Loan-Level Disclosures

1. Will providing loan level disclosures make the proposed pool security more attractive to a larger market?

2. Which loan-level attributes could SBA provide that would be the most beneficial?

3. What types of disclosures or reports would be preferable with a new pool security?

4. What is the preferred method of receiving loan-level data and security-level data? Would using a disclosure portal to generate reports and download data files be a helpful resource?

5. What features of a customer-facing disclosure tool might increase participation in the SBA secondary market 7(a) loan pooling program?

6. What effect would the publication of robust loan-level disclosures have on the pricing of the proposed pool security?

D. Questions About Book-Entry Registration

1. Currently, Pool Certificates are registered in physical certificate form. Would there be a benefit to the new pool security being registered in book-entry form? If so, what would those benefits be?

2. What additional process or technology changes would be needed to support a book-entry security?

3. What effect would book-entry registration have on the pricing of the proposed pool security?

E. New SBA Secondary Market 7(a) Loan Pool Security General Comments

SBA is seeking comments and recommendations on changes to the current pool security for the 7(a) loan program to better align underlying loan collateral and pool cash flows and to sustain the long-term viability of the 7(a) loan pooling program. SBA also requests comments on the proposed cash flow alignment, the timely payment of scheduled interest and actual principal, loan-level disclosures, and book-entry registration.

We value your comments and ask that you provide a rationale for any suggested changes or recommendations.

Jovita Carranza,
Administrator.

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