

Loan Sales: Another Step in the Evolution Of the Short-Term Credit Market

By Sean Beckett and Charles S. Morris

Loan sales by commercial banks have increased dramatically in recent years. More and more banks are selling their loans, and individual banks are selling larger volumes of loans. This practice takes many forms. One familiar form is the pooling of mortgage loans by such agencies as the Government National Mortgage Association and the subsequent sale of securities representing undivided interests in these mortgage pools. More recently, banks have begun pooling other kinds of loans: automobile loans, credit card and lease receivables, agricultural loans, even pools of charged-off loans. In addition to pooling loans, some banks are selling whole, short-term commercial and industrial loans. This entire range of activities, from the sale of shares in a pool of loans to the sale of whole loans, is called securitization.

The recent increase in securitization has raised a host of concerns about the effects of these loan

sales on the safety and soundness of banks. One concern is the effect of securitization on the riskiness of individual bank and thrift loan portfolios. Another concern arises from the similarity of loan sales to underwriting securities, an activity commercial banks have been restricted from undertaking since passage of the Banking Act of 1933.

This article examines one aspect of securitization: the sale of whole, short-term loans, especially by large money center banks. It is argued that, instead of being a cause for concern, the recent increase in bank sales of whole, short-term loans is merely the latest development in the evolution of the short-term credit market. Moreover, loan sales do not appear to decrease the safety and soundness of banks. As a result, the increase in bank loan sales is likely to contribute to a smoother functioning short-term credit market.

The first section of the article reviews the history of the short-term credit market before the 1980s. Special attention is given to the development of the market for nonfinancial corporation commercial paper. The second section documents the rise

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in loan sales, considers some of the reasons for the rise, and discusses the innovative aspects of loan sales that ensure their continued importance. The final section examines the public policy issues surrounding the increase in loan sales.

The short-term credit market prior to the 1980s

To understand the role of loan sales in the short-term credit market, it is useful to look at the short-term credit market before the 1980s. This section discusses the traditional organization of the short-term credit market and explains the emergence of nonfinancial corporation commercial paper in the 1960s.

The short-term credit market before the 1960s

Until the 1960s, nonfinancial business firms relied almost entirely on banks rather than capital markets to meet their short-term financing needs. Nonfinancial firms typically obtained short-term bank loans to finance inventories and meet seasonal and other working capital needs. While these types of credit needs are recurring, the term of the credit is so short that, in the past, it was impractical for most firms to obtain these funds from capital markets.

Close, long-standing ties between banks and nonfinancial firms made banks ideal as the source of short-term credit. A bank can correctly assess and monitor a firm's creditworthiness only by maintaining a close relationship with the firm. A firm may be thoroughly sound, but only someone intimately familiar with its management and prospects—in other words, only its bank—has enough confidence in the firm's ability to meet its financial obligations to advance it funds. Also, a bank is well suited to renegotiating loans to a firm if the firm suffers unexpected reverses.

Although most nonfinancial firms relied on banks to meet their short-term credit needs, firms

that were nationally known had more short-term financing options available than less-known firms. The management and prospects of Fortune 500 firms, say, are so well known that large institutional investors might be willing to make short-term loans directly to these firms. Again, the key factor is information. A nationally known firm might not be any more creditworthy than a local firm, but the larger firm's condition is monitored by an array of securities market participants. The condition of a local firm is monitored only by its bank. Hence, only the bank is in a position to assess a local firm's creditworthiness. Nevertheless, until the 1960s, nationally known firms rarely made use of nonbank financing options.

The advent of commercial paper

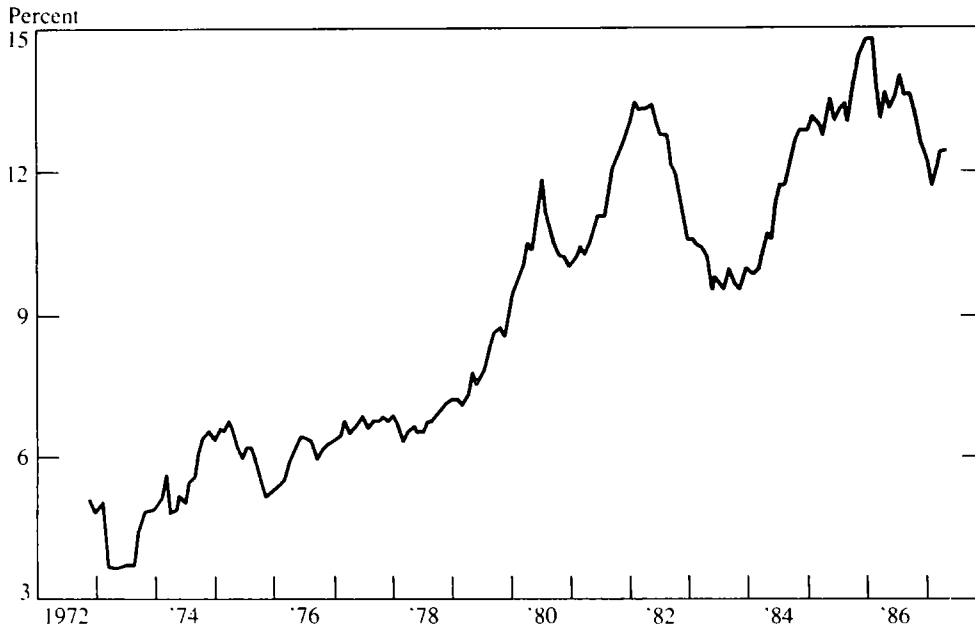
A major change in the provision of short-term credit to nonfinancial firms came with the rise of commercial paper in the late 1960s. Until then, commercial banks dominated the short-term credit market. In the second half of the 1960s, however, market interest rates rose above Regulation Q interest rate ceilings on large deposits, making it temporarily difficult for banks to raise the funds needed to meet the demand for short-term business loans. In the interim, some large, nationally known nonfinancial firms turned to meeting their short-term credit needs by issuing commercial paper through investment banks.¹

Commercial paper is a short-term promissory note typically unsecured and issued in bearer form.² Like other corporate debt securities, com-

¹ Until recently, commercial paper has been issued through investment banks rather than commercial banks because the Banking Act of 1933 was thought to prohibit commercial banks from underwriting commercial paper. That situation changed somewhat in recent years, a point discussed more fully below.

² For a more detailed discussion of commercial paper, see Timothy D. Rowe, "Commercial Paper," *Instruments of the Money Market*, Federal Reserve Bank of Richmond, 1986, pp. 111-125.

CHART 1
Percentage of nonfinancial corporation
commercial paper in short-term business debt



mercial paper is given a rating to indicate the issuer's ability to repay. Two features of commercial paper make it desirable from the viewpoint of both the issuer and investor—its flexible maturity and its flexible denomination. The maturity of commercial paper ranges from one to 270 days, and, within that range, maturities can be tailored to the needs of individual investors.³ Most issues have a maturity between five and 45 days, the most popular being 30 days. The denomination of commercial paper also can be tailored to the individual investor, the most common being \$1 million. Purchasers of commercial paper are usually institutional investors.

³ Commercial paper issues rarely have a maturity greater than 270 days, because securities with longer maturities must be registered with the Securities and Exchange Commission and registration is very costly.

The importance of nonfinancial corporation commercial paper as a source of short-term credit has increased substantially over the last 15 years. Since the rapid rise in nonfinancial corporation commercial paper in the 1960s, the commercial paper market has become larger than the market for any other money market instrument except Treasury bills. Chart 1 shows the percentage of nonfinancial corporation commercial paper in short-term business credit.⁴ The share has more than tripled over the period shown, rising from an average of only 4 percent in 1973 to 14 percent in 1986. This 1986 share represents \$82 billion in nonfinancial corporation commercial paper out

⁴ Short-term business credit is defined as the sum of commercial and industrial loans and outstanding nonfinancial corporation commercial paper.

of a total of \$593 billion in short-term business credit that year.

The importance of nonfinancial corporation commercial paper as a source of short-term credit has increased because, for many large nonfinancial firms, commercial paper is cheaper than bank loans. Firms in the top two rating categories can usually borrow in the commercial paper market at rates lower than bank loan rates, although firms in the second rating category pay a substantial premium over firms in the top category. Commercial bank loans are more expensive than commercial paper because commercial banks have to cover costs that investment banks do not, such as deposit insurance premiums and capital and reserve requirements. As a result, many nonfinancial firms that turned to commercial paper in the late 1960s have continued to rely on commercial paper rather than return to bank loans. In fact, commercial paper has supplanted bank loans as the primary source of short-term credit for many of the country's largest nonfinancial corporations.

To recover some of the business lost to the commercial paper market, banks have tried in recent years to place and underwrite commercial paper.⁵ Commercial banks are allowed to place third-party commercial paper, and the Board of Governors of the Federal Reserve System has recently ruled that several large bank holding companies can underwrite limited amounts of commercial paper through subsidiaries that are not "principally engaged" in underwriting impermissible securities.⁶ However, the recently enacted Competitive

⁵ "Underwriting" is purchasing new securities and selling them in the open market. "Placing" is locating investors, through direct contact, to purchase new securities.

⁶ Impermissible securities include all securities except those that banks are explicitly allowed to underwrite by the Glass-Steagall Act. The Federal Reserve Board has ruled that a subsidiary is not principally engaged in the underwriting of impermissible securities if its revenues from such underwriting are less than 5 percent of its total revenues. The Federal Reserve also has placed other restrictions on the activities of subsidiaries.

Equality Banking Act of 1987 has placed a moratorium on this and other new bank activities until March 1, 1988.

Loan sales—the next development in the short-term credit market

Loan sales by commercial banks have increased significantly in recent years. This section examines the recent increase in loan sales by commercial banks and argues that loan sales are simply the next step in the evolution of the short-term credit market.

The recent rise in loan sales

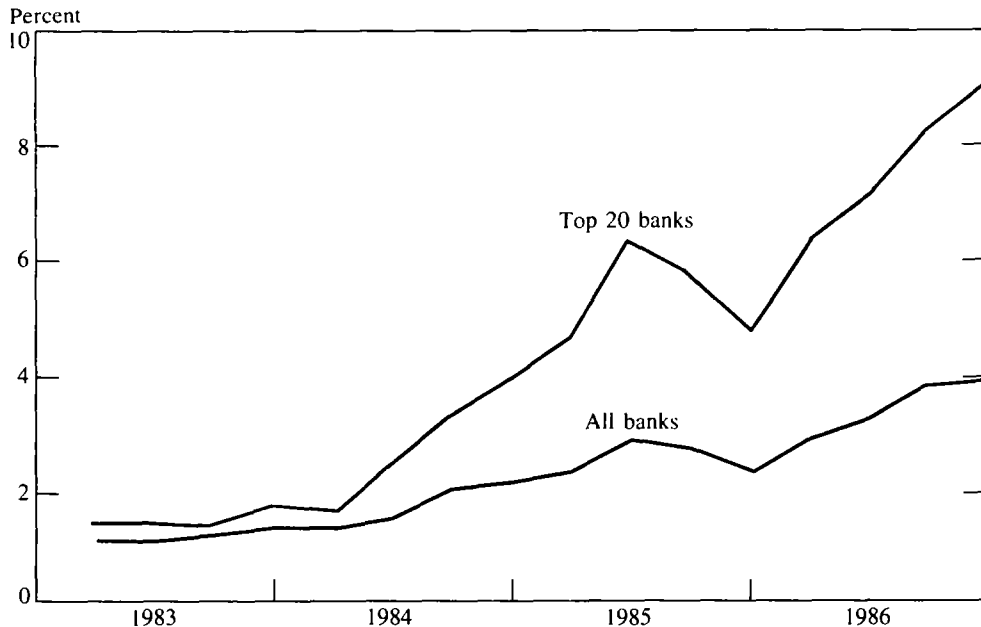
Various types of transactions are lumped together under the single term "loan sale."⁷ The simplest type—the one considered in this article—is where a bank sells a single loan without recourse to another investor.⁸ In a loan sale without recourse, all risk of default is transferred from the bank to the purchaser of the loan. At the conclusion of the transaction, the loan is taken off the

⁷ The varieties of loan sales, bankers' motives for undertaking them, and the regulatory issues involved are all discussed in more detail in Sean Beckett, "Understanding Loan Sales," *Financial Letter*, Federal Reserve Bank of Kansas City, April 1987, and in David G. Hayes, "Some Issues in Asset Securitizations by National Banks," *Issues in Bank Regulation*, Winter 1987, pp. 5-14.

⁸ Banks also sell loans with recourse, that is, banks retain a share in the losses if the borrower defaults. This type of loan sale is treated as a financing. In this case, the bank must usually keep the loan on its balance sheet, and it may have to hold required reserves against the proceeds from the loan sale. Banks use loan sales with recourse to lower their cost of funds.

Another kind of loan sale that has become more important recently is the sale of securities representing an undivided interest in a pool of similar loans. A familiar example of such a loan-backed security is the mortgage-backed securities sold by the Government National Mortgage Association and the Federal National Mortgage Association. Other more recent examples are securitized credit card balances and automobile loans. This type of loan sale is an important development in its own right, but it is not directly related to the short-term business credit market.

CHART 2
Loan sales as a percentage of bank assets



bank's books and the purchaser of the loan takes the place of the bank in future dealings with the borrower. For a fee, the bank may service the loan. In this loan sale without recourse, as it is termed, the bank reduces its assets and, thus, reduces its required capital. For banks, this feature is one of the attractions of loan sales without recourse.

Loan sales have increased markedly in the last few years. Chart 2 records the growth in importance to banks of loan sales over the last four years.⁹ In the second quarter of 1983, the ratio of loans sold to commercial bank assets was 1.2 per-

cent (\$27 billion of loan sales in 1982 dollars). By the first quarter of 1987, the loans sold to assets ratio had risen to 4.0 percent (\$115 billion of loan sales). The rise in this ratio has been even more dramatic at the 20 largest banks, where size is measured by assets. The ratio of loans sold to assets at these banks rose from 1.5 percent (\$12 billion) in the second quarter of 1983 to 9.1 percent (\$82 billion) in the first quarter of 1987.

Why banks are selling loans

The rapid rise in loan sales has led to increased interest in why banks are selling loans. Several explanations have been offered. One explanation is that banks are selling loans as a substitute for not being able to sell commercial paper. Another explanation is that reduced profit margins have led banks to look for new sources of revenue. Still

⁹ The statistics reported in this subsection were calculated from the Consolidated Reports of Condition and Income that insured banks file with the FDIC every quarter. The reports began recording the volume of loan sales without recourse in the second quarter of 1983.

another explanation is that banks are simply responding to an increased demand for the short-term debt of highly rated corporations.

Many observers have advanced the notion that commercial banks are increasing their sales of whole loans because they cannot deal in commercial paper.¹⁰ Like commercial paper, the loans banks sell are generally the short-term debt of highly rated nonfinancial firms. Thus, this explanation asserts that commercial banks, concerned about the encroachment of commercial paper on their traditional stronghold—the short-term business credit market—use loan sales to skirt the legal prohibitions against their dealing in commercial paper.

The more rapid growth in loan sales in the 20 largest banks than in all banks is consistent with the notion that much of the increase in loan sales reflects competition with commercial paper. Most commercial paper is issued by the highest rated nonfinancial firms. For that reason, only their banks—the largest banks in the country—are in direct competition with the commercial paper dealers. By the same token, the commercial and industrial (C&I) loans easiest to sell to the investors who buy commercial paper are those made to highly rated firms. It turns out that the increase in loan sales is more pronounced at the large money center banks. If the increase in loan sales were spread uniformly across banks of all sizes, these loan sales would more likely reflect only

an increase in traditional commercial banking activities.

Chart 3 reinforces the idea that the money center banks are responsible for the increase in loan sales. The chart shows the percentage of commercial banks with loan sales equal to at least 1 percent of their assets for all banks and for the 20 largest banks.¹¹ Twenty percent of all banks had loan sales equal to at least 1 percent of their assets in the second quarter of 1983. By the first quarter of 1987, that fraction had fallen to 17 percent of all banks. In contrast, there has been a pronounced increase in this fraction for the 20 largest banks. The percentage of the 20 largest banks with loan sales equal to at least 1 percent of assets rose from 50 percent in the second quarter of 1983 to 75 percent in the first quarter of 1987. In other words, all but 5 of the 20 largest banks had a loans sold to assets ratio of at least 1 percent in the first quarter of 1987.

Charts 2 and 3 document the marked increase in the importance of loan sales and support the notion that competition with commercial paper is one reason for the increase. However, other factors are also important in accounting for this development.¹² One factor is the decline in the profitability of traditional lending. A recent study by the Federal Reserve Bank of New York concluded that bank profitability has declined in the 1980s and is now close to a 15-year low.¹³ The study emphasizes the decline in net interest

¹⁰ Some representative articles are "Roundtable on Loan Sales," special supplement to *Bank Letter*, March 16, 1987; Lowell Bryan, "The Selling of America's Loans," *The Wall Street Journal*, October 20, 1986, p. 20; Carol Kizzia, "What's behind the growth in asset sales?" *ABA Banking Journal*, March 1987, pp. 32-36; George F. Salem, *Commercial Loans For Sale: The Marriage of Commercial Banking and Investment Banking*, Donaldson, Lufkin & Jenrette, September 30, 1985; George F. Salem, "Loan Selling: A Banking Revolution," an address to the 72nd Annual Fall Conference of Robert Morris Associates, reprinted by Donaldson, Lufkin & Jenrette, October 10, 1986.

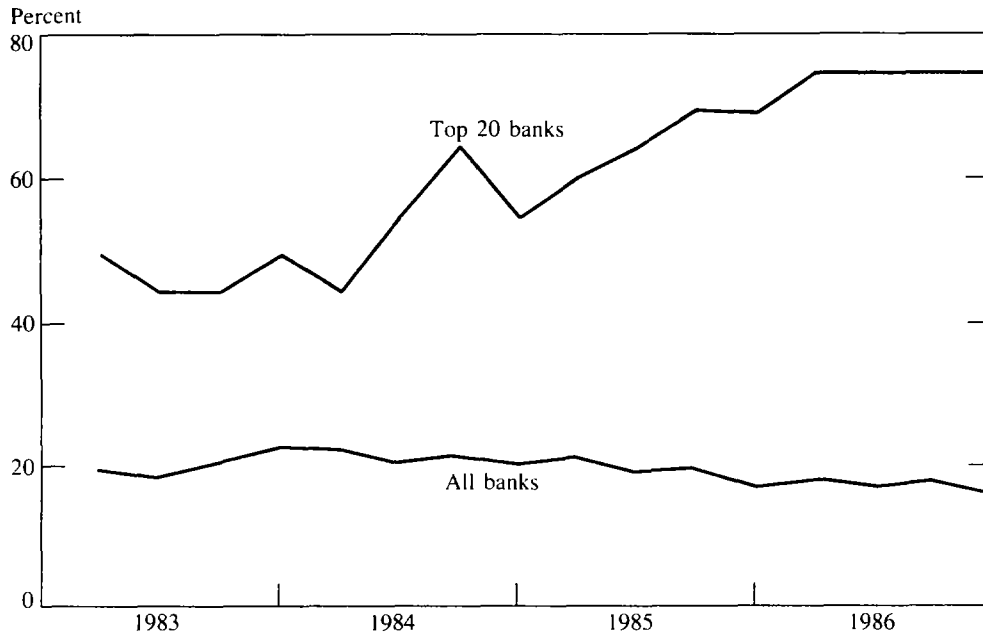
¹¹ A preliminary examination of the data indicates that a cutoff of 1 percent of assets appears to separate banks that are active loan sellers from banks that sell loans only intermittently.

¹² One reason that the rise in nonfinancial corporation commercial paper cannot entirely explain the rise in loan sales is that nonfinancial corporation commercial paper has been encroaching on C&I loans since the mid-1960s but the significant rise in loan sales did not begin until the 1980s.

¹³ *Recent Trends in Commercial Bank Profitability—A Staff Study*, Federal Reserve Bank of New York, September 1986.

CHART 3

Percentage of banks with loans sales to assets ratios above 1 percent



margins as a causal factor in reducing bank profits and notes that banks have been shifting out of traditional loan-funding activities into fee-based intermediation activities. One such activity is the selling of whole short-term loans.¹⁴

Another reason for the increase in loan sales—and one not directly related to the squeeze on bank profits—is an apparent increase in demand for the short-term debt obligations of highly rated corporations. Some of this demand comes from regional banks wanting to diversify their asset

portfolios but not having direct ties with top-rated corporations. Another source of demand for these credits is foreign banks and foreign institutional investors that might want to hold high-quality, short-term, dollar-denominated debt.

Innovative aspects of loan sales

Loan sales have become important in much the same way that nonfinancial corporation commercial paper became important in the 1960s. Non-financial corporation commercial paper became prominent in the late 1960s in response to a temporary misalignment of interest rates. In the process, however, highly rated corporations found that commercial paper has some advantages for them over traditional bank loans. As a result, the commercial paper market has remained an important part of the short-term credit picture. In the same

¹⁴ The decline in bank profitability also helps account for the timing of the increase in loan sales. In the early 1970s, banks could offset the loss of any profits due to the loss of C&I loans to non-financial corporation commercial paper by making more foreign loans. But this avenue was not open in the 1980s. In fact, banks have made fewer foreign loans in the 1980s because of the LDC debt crisis.

way, loan sales may have emerged as a temporary solution to the combination of the competitive threat of the commercial paper market and the lowered profitability of funding loans to maturity. And like commercial paper, there are innovative aspects of loan sales not found in other short-term credit instruments that may guarantee them a role in credit markets even after banking conditions change.

One innovative aspect of loan sales is that they are an asset that can fill the gap between commercial paper and traditional bank loans for credit-worthy but less well-known firms. Most loan sales so far have involved highly rated borrowers, firms that could have issued commercial paper. More and more though, banks are selling the loans of firms that are good credit risks but are not highly rated and, therefore, do not ordinarily have access to the commercial paper market.

Loan sales can fill this gap in a way that commercial paper cannot because commercial banks are better able to monitor a borrower's financial condition. Commercial paper is simply an IOU, a corporation's promise to pay. The purchaser of commercial paper has no way of monitoring the borrower's condition, and the commercial paper dealer bears no responsibility for the borrower's creditworthiness. Instead, commercial paper purchasers rely on the securities rating agencies, such as Moody and Standard and Poor, to determine and monitor the quality of the credit. As the loan sales market is now structured, banks sell loans of their regular customers, firms with a creditworthiness that the bank has been regularly monitoring. In effect, the bank serves as a rating agency for these firms. Although the bank does not share in the loss of a sold loan that turns sour, no bank can continue to prosper as a loan merchant if its reputation for controlling quality is suspect.

A second innovative aspect of loan sales is the option of having the bank continue servicing the loan. Since the bank has many other dealings with

its customers besides the loans it sells, the bank can probably service the loan and work out any problems at lower cost than any other firm. With commercial paper, the purchaser of the paper bears responsibility for collecting the funds due.

A third innovative aspect of loan sales relative to commercial paper is the flexibility of the terms of a bank loan. As commercial paper is simply an IOU, it is not designed to cover complicated contingencies, which is one reason that only highly rated, nationally known firms are able to issue commercial paper. But a bank loan is often tailored to take account of the borrower's particular circumstances. Specific performance and oversight clauses can be incorporated in the loan contract. This flexibility again reflects the commercial bank's intimate knowledge of its customers and its ability to guide their behavior to reduce the likelihood of loan default.

In summary, it is clear that loan sales are the latest development in the evolution of the short-term credit market. The volume of loan sales has increased markedly in recent years. The concentration of these loan sales in large, money center banks is consistent with the idea that these loan sales are different from the familiar loan participations of the past. Finally, the innovative aspects of loan sales set them apart from both commercial paper and traditional short-term business lending and suggest that loan sales will continue to be important in the short-term credit market.

The effect of loan sales on the safety and soundness of banks

The rise in loan sales and the prospect that their prominence will continue have raised a host of concerns among regulators and policymakers about the effects of loan sales on the safety and soundness of banks. Some are concerned that banks are weakening their loan portfolios by selling the highest quality loans, while others are concerned that banks are bearing entirely new risks

associated with selling loans as opposed to holding loans—the risks of underwriting. This section examines these issues and argues that, on balance, loan sales do not appear to decrease the safety and soundness of banks.

Some observers have expressed the concern that by selling the least risky loans from their portfolio, banks are weakening their loan portfolios and increasing their riskiness.¹⁵ However sales of existing loans are only a small fraction of all sales of short-term C&I loans—most of the sold loans are loans that are sold immediately after they are made.¹⁶ As a result, loan sales have little effect on bank loan portfolios—the loans that are sold were never in bank loan portfolios in the first place.

Why does a bank make loans only to sell them, especially when the borrowers are often the highest rated nonfinancial corporations? The reason is that the bank cannot afford to hold these loans. A bank has to pay deposit insurance premiums on and provide reserves for the liabilities used in funding loans. The bank also has to hold capital against the loan. For these reasons, bank-funded loans are more expensive for highly rated borrowers than commercial paper. Only if the bank sells the loan can the bank offer its best customers loans at competitive rates. However, by making and then selling such a loan, the bank maintains its relationship with a highly rated customer and, thereby, paves the way for selling

this customer other bank services. In other words, a bank may have to sell its best loans to keep its best customers.¹⁷

Other observers are concerned that banks are bearing underwriting risk, and thus impairing bank safety, when they make loans only to sell them. The risk associated with underwriting a security is that the price of the security will fall between the time the underwriter buys the security and sells it. Although bank loans are not legally securities, there is no significant economic difference between the underwriting of commercial paper securities by investment banks and the sale of short-term C&I loans by commercial banks. This concern over loan sales, therefore, arises from the belief that underwriting activities are riskier than commercial banking activities and the recognition that selling whole, short-term bank loans is essentially the same as underwriting other kinds of short-term business debt.

Actually, combining underwriting-like activities, such as loan sales, with traditional commercial banking is likely to reduce, rather than increase, the risks of commercial banking. It is not at all clear that this kind of underwriting is riskier than traditional commercial banking activities. If a bank makes a loan and holds it in its portfolio, the bank bears default, interest rate, and liquidity risk. But if the bank sells the loan, it only bears underwriting risk while the purchaser bears the risks associated with traditional commercial bank lending. In the case of bank loan sales, however, underwriting risks are minimized because commercial banks need not make a loan until a buyer has been found. For the short-term credits considered here, this practice is common. To argue

¹⁵ Although the loans sold in whole loan sales are usually high-quality loans, this is not always the case. Latin American loans have been sold, as have charged-off loans, and several investment banks are working to securitize nonperforming and underperforming domestic and international loans.

¹⁶ In fact, banks reduce their riskiness by selling loans from their portfolios, even when they sell their best loans. As an example, consider the case of a bank that sells the loan that is least likely to default. The riskiness of the remaining loan portfolio has increased, but the riskiness of the bank as a whole has decreased because the bank has traded a risky asset for riskless cash.

¹⁷ It could be argued that bank loan sales may increase default risk because banks that sell loans have less incentive to monitor the creditworthiness of the borrower. But, if a bank wants to pursue loan sales as a regular line of business, it will try to build a reputation for effectively monitoring the condition of borrowers.

that loan sales increase bank riskiness, therefore, requires showing that this small underwriting risk is greater than the combined default, interest rate, and liquidity risk the bank would bear if it held the loan.¹⁸

Even if underwriting is riskier than commercial banking, a commercial bank might reduce its overall riskiness by diversifying into some underwriting activities. By virtue of its diversified portfolio, a bank that makes loans to a wide variety of firms and individuals is safer than a bank that makes loans to only a single class of borrowers, no matter how creditworthy. In the same way, a bank that both makes loans and underwrites securities might be safer than a bank that engages in only one or the other activity. To the extent banks can reduce their overall riskiness by engag-

¹⁸ A precise calculation of the change in bank riskiness would also take account of the correlation between underwriting risk and lending risk.

ing in such underwriting activities as selling loans, loan sales may increase the safety and soundness of the banks.

Conclusion

The increase in sales of whole short-term loans by commercial banks in the 1980s reflects banks' response to the competitive pressure of the commercial paper market, to the steady decline in the profitability of traditional lending, and to an increased demand for the debt of highly rated firms. Viewed in the perspective of the continuing development of the short-term business credit market, loan sales appear to be a natural extension of commercial banks' role as financial intermediaries. Moreover, loan sales do not appear to reduce the safety and soundness of banks. To the extent that loan sales combine the desirable aspects of traditional loans and of commercial paper, loan sales can improve efficiency and lower costs in the short-term credit market.