



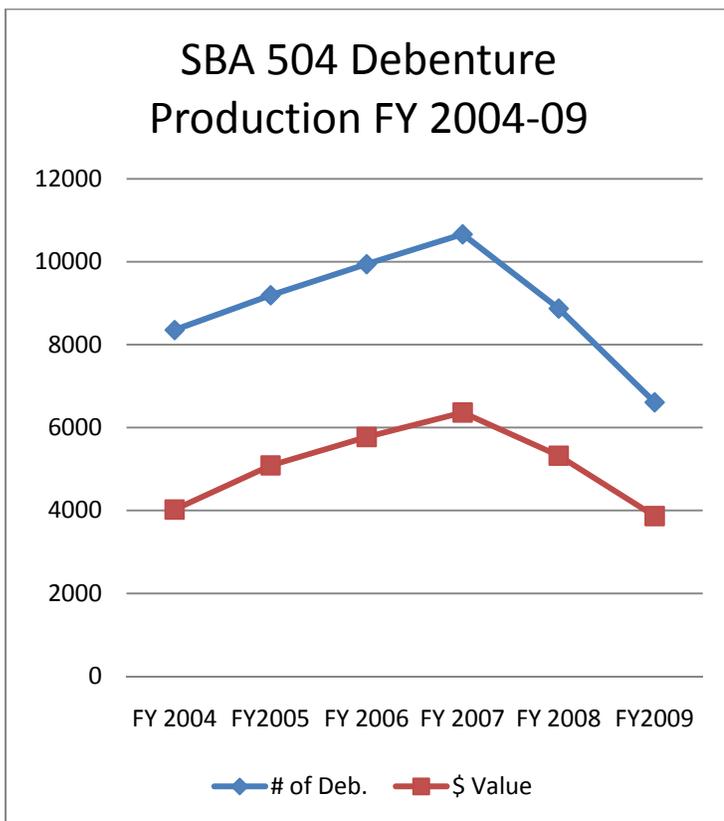
## INSIDE THE INDUSTRY

### The Second Coming of the 504 Secondary Market

“Once upon a seemingly long time ago, in a lending market far, far away, lenders could sell the first lien position loans resulting from 504 projects ...”

Before the recent unpleasantness, the secondary market allowed lenders to: realize substantial premium revenue, expand their credit box, minimize concerns over portfolio concentration, manage capital allocation, manage liquidity, and provide borrowers with a wide range of amortizations and rate structures. In short, the secondary market for 504 first lien position loans was an exceptionally useful tool.

Since September 2008, the market has almost effectively ceased to exist. Most of the major buyers exited the market and credit standards tightened so dramatically that pricing and structures were not meaningful discussions. While SBA has traditionally not tracked 504 first lien position loans (whether sold or retained) beyond basic production statistics, there is no doubt that some of the recent drop in 504 production must be related to the collapse of this market.



If nothing else, for the past sixteen months, all credit has become local as lenders were forced to deal with local constraints: capital adequacy, liquidity, and portfolio concentrations, the impact of which, no doubt, contributed to the drop off in 504 production. Discussion of the problems in securitization markets was the topic in the cover article of *Barron's* December 28, 2009 issue (“A Flat Dow for 10 Years? Why It Could Happen”). A group of economists, sometimes referred to as “the liquidity movement” believes that a failure to resuscitate securitization mechanisms may have tremendous consequences for the entire economy.

In the *American Recovery & Reinvestment Act (ARRA)*, passed in February 2009, Section 503 contained a provision for a series of steps to resuscitate the 504 secondary market. On November 5, 2009, SBA released the program guidelines, which may be accessed at:

[http://www.sba.gov/idc/groups/public/documents/sba\\_program\\_office/bank\\_503loan\\_guide.doc](http://www.sba.gov/idc/groups/public/documents/sba_program_office/bank_503loan_guide.doc)

It is expected that within the next several weeks, there will be an effort by any one of several industry groups to take advantage of this provision and to begin to assemble loan pools for securitization.

The proposed regulations allow for lenders to sell a portion of the first lien position loan which will be backed by a guarantee from the SBA. The guaranteed portion will be for 80% of the amount of the first lien position loan and will cover principal and timely payment of interest, with said guarantee flowing to the *investor*. Additionally, 5% of the first lien position loan must be transferred to a pooler who will conduct the securitization. The pooler is required to hold that 5% portion on their books.

This begs the question: what becomes of the 15% remainder?

It is believed that lenders will be extremely interested in selling the whole first position loan to remove it from their books, thereby regaining capital and loan loss reserves—in addition to the premium which a pooler will pay for the guaranteed portion. Furthermore, this will simplify accounting for the transaction as a true sale.

Anyone buying, or for that matter retaining, the 15% must comply with certain SBA regulations and procedures, the critical one being that they agree to undertake the servicing and possible liquidation of the entire loan in accordance with SBA policy and procedures. (13 CFR 120.1712-17) The true rub of these obligations is under 120.1713: “SBA is entitled to recover from the Seller losses incurred by SBA on its guarantee of a Pool if such losses resulted because Seller's Pool Loan was not made and closed in a commercially reasonable manner, consistent with prudent lending standards, and in accordance with any applicable Program Rules and Regulations.”.

In essence this makes participation in the newly reconstituted 504 first lien position loan securitization look a great deal like the 7(a) program. Participants are potentially liable for guarantee payments made by SBA to investors under the above circumstances. While guarantee purchase reviews are part of life for 7(a) participants, they are a totally new territory for 504 participants where one of the historic attractions of the program was the relative lack of SBA compliance requirements on the first lien position lender.

The trade-off between the flexibility of an active secondary market and the restrictions of compliance with guarantee purchase requirements will be only one of the hurdles to be cleared in the effort to resuscitate the 504 secondary market for first lien position loans. It remains to be seen if capital and liquidity pressures will motivate lenders to participate or if there will be sufficient participation from poolers to create a range of product and pricing of interest to lenders. There is, however, little doubt that absent this effort, the scope of secondary market options for 504 first position lien loans will be as limited as the overall commercial mortgage backed securities (CMBS) market.

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