

SMALL BUSINESS ADMINISTRATION

Notice of Changes to SBA Secondary Market Program

AGENCY: U.S. Small Business Administration ("SBA").

SUMMARY: The purpose of this notice is to provide the public with notice of program changes in SBA's Secondary Market Loan Pooling Program. These changes are being made to conform the timely payment guaranty of this program to the budgetary effects of having this program under the Federal Credit Reform Act of 1990. The changes described in this notice will be incorporated, as needed, into the Guaranteed Loan Pool Certificates for the 7(a) loan program (the "Pool Certificates"), the Secondary Market Program Guide, and all other appropriate secondary market documents.

DATES: The changes in the Notice will apply to loan pools with an issue date on or after October 1, 2004.

ADDRESSES: Address comments concerning this notice to James W. Hammersley, Director, Loan Programs Division, U.S. Small Business Administration, 8th floor, 409 3rd St. SW., Washington, DC 20416 or james.hammersley@sba.gov.

FOR FURTHER INFORMATION CONTACT: James W. Hammersley, Director, Loan Programs Division, U.S. Small Business Administration, 8th floor, 409 3rd St. SW., Washington, DC 20416 or james.hammersley@sba.gov.

SUPPLEMENTARY INFORMATION: When Congress enacted the Small Business Secondary Market Improvements Act of 1984, it authorized SBA to guarantee the timely payment of principal and interest on trust certificates representing an ownership interest in a pool of guaranteed portions of loans made under SBA's section 7(a) guaranteed loan program ("SBA 7(a) loans"). Congress anticipated that the timely payment guarantee could be structured so that SBA would have no additional budgetary exposure and no need for any direct taxpayer subsidy of this cost.

SBA established the Master Reserve Fund ("MRF"), which has served as a self-funding mechanism to cover the cost of the timely payment guaranty. Borrower payments on the guaranteed portion of pooled SBA 7(a) loans, as well as any SBA guaranty payments on defaulted SBA 7(a) loans, are deposited into the MRF and all payments to investors ("Registered Holders") are made from the MRF. Interest earned while the payments are in the MRF is used, as needed, to make the timely payments to the Registered Holders. In its 18 year existence, there have always been sufficient funds in the MRF to meet SBA's timely payment obligations.

However, SBA, in consultation with the Office of Management and Budget, and the SBA's financial statement auditor, recently determined that the timely payment guaranty must conform to the requirements of the Federal Credit Reform Act of 1990 ("FCRA"), 2 U.S.C. 661 *et seq.* Under FCRA, SBA is required to develop a model of MRF activity to estimate whether there will be sufficient funds in the MRF to meet the timely payment obligations to the Registered Holders for each loan pool. This is the same process that SBA follows every year to estimate the subsidy cost of the section 7(a) and section 504 loan programs. This subsidy model is developed based on assumptions related to several factors, including interest rates and prepayments over the life of the pools. SBA used the same loan performance and economic assumptions to develop the subsidy rate for the section 7(a) program. SBA's forecast for pools to be originated in FY 2005 (the "FY 2005 pools") indicates that the interest that will be earned in the MRF in connection with the FY 2005 pools will not be sufficient to make all timely payments of principal and interest due to the Registered Holders under the current program terms. Under FCRA, SBA must address this shortfall. Therefore, SBA has decided to make minor program changes that will allow the program to operate at no cost to the taxpayers rather than seek authority to assess a fee. These changes will affect how certain payments are passed through to the Registered Holders, including the first principal payment as well as the amounts paid to the Registered Holders after prepayments are made in whole or in part. These changes will cause an increase in the constant prepayment rate.

To understand the program changes, it would be helpful to first summarize certain features of the loan pooling program. To facilitate the formation of loan pools, SBA permits loans of differing maturities to be put into the same pool. The Pool Certificates have the maturity of the longest loan in the pool. Borrower payments are received based on the amortization schedule in the borrower's note and paid out to Registered Holders based on the amortization schedule of the Pool Certificate. Loans with a maturity shorter than the maturity of the pool add more money each month to the MRF than is being paid out for that particular loan to the Registered Holders each month. When a loan with a maturity shorter than the pool maturity is paid in full, the excess that has accumulated in the MRF is paid to Registered Holders over the remaining life of the pool. This process is followed for each loan in a pool until pool maturity or until the last loan in the pool is prepaid, if earlier. At that time, all funds owed to Registered Holders are paid to them. Although this practice allows an excess of funds to accumulate in the MRF in the short run (the "amortization excess"), it results in a long-term cost to the MRF because the amortization excess earns interest at a lower rate than the rate that is ultimately paid to the Registered Holders. SBA expected earnings on other cash flows to offset this shortfall.

The following is a description of pool payment under the system that has been in place since SBA began to issue Pool Certificates in 1985:

1. The first payment to a Registered Holder is interest only.
2. Beginning with the second payment and continuing over the life of the pool, payments to the Registered Holder consist of principal and interest.
3. When a loan in a pool is prepaid in full (whether through voluntary borrower prepayment or SBA guaranty payment upon the loan's default), the amount that is passed through to Registered Holders is the principal and interest that was received at the time of prepayment. Thus, if a seven year loan in a 10-year pool is prepaid in year three, the

Registered Holder receives only that borrower's prepayment. The amortization excess that had accumulated on that loan in years one through three remains in the MRF and is paid out in years seven through ten or when the pool expires, whichever is earlier.

4. If a borrower makes a partial prepayment, the amount paid is deposited in the MRF and, like the amortization excess, is paid to the Registered Holders over the life of the pool. (In the case of the above example, payout would be in years seven through ten or when the pool expires if earlier.)

In order to ensure that this program can be maintained on a self funding basis, SBA is making the following three changes to the program: (1) The first payment to Registered Holders will now consist of principal and interest instead of being interest only; (2) SBA will now pass through with a prepayment in full all funds related to the prepaid loan, including the amortization excess from the loan if it has a shorter maturity than the pool; (3) partial prepayments made during the life of the loan will be passed through on the next scheduled payment date. SBA is making these changes pursuant to its authority under section 5(g)(2) of the Small Business Act, 15 U.S.C. 634(g)(2).

Thus, effective for all pools with an issue date on or after October 1, 2004, the following will be the procedures used to govern payments to Registered Holders:

1. The first payment to a Registered Holder will consist of principal and interest.
2. All subsequent payments made to the Registered Holder will also consist of principal and interest.
3. When a loan in a pool is prepaid in full, the amount that is passed through to Registered Holders will be the principal and interest that was received at the time of prepayment plus any amortization excess associated with that loan that has accumulated in the MRF. Thus, if a seven year loan in a 10-year pool is prepaid in year three, the prepayment will be passed through to Registered Holders along with the amortization excess on that loan that had accumulated in the MRF. The timing of the pass through of the prepayment funds will not change.
4. If a borrower makes a partial prepayment, the principal and interest prepaid will be passed through to Registered Holders with the next scheduled payment. Any amortization excess will remain in the pool to term or expiration.

These program changes will be incorporated as necessary into the appropriate secondary market documents. The language above will supercede any previous description of pool payments, including that in the SBA Secondary Market Program Guide.

It is important to note there is absolutely no question or doubt that SBA will honor its obligation to guaranty the timely payment of amounts owed to Registered Holders under the full faith and credit of the United States on those pools issued prior to October 1, 2004 and any subsequent pools. SBA has modeled the pre-FY2005 pools and, based on current assumptions and predictions, determined that there are sufficient funds in the MRF to meet the timely payment obligation through 2017 for the pools originated through FY 2004. However, SBA projects that after 2017 the MRF will be short in meeting this obligation by about \$105 million, in current dollars, or about .8% of the total obligation. Because the program is under FCRA, this shortfall will be covered by money advanced from the U.S. Treasury. If any shortfall were to occur in a pool issued after October 1, 2004, it would also be covered by funds from the U.S. Treasury, per the FCRA.

Authority: 15 U.S.C. 634(g)(2).

Dated: September 15, 2004.

Hector V. Barreto,

Administrator.

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