THE LOAN SALES MARKET

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Latest Revision: September 1988

Forthcoming in Research in Financial Services, ed. by G. Kaufman

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The assistance, explanations, and suggestions of Robert Barmore, Robert Bergesch, Iqbal Quadir, Craig Shallcross, and members of the University of Pennsylvania Macro Lunch Group are greatly appreciated. The authors also appreciate the assistance of Andrew Albert of Asset Sales Report. The research assistance of Sung-ho Ahn, Eun Kang, Arvind Krishnamurthy, and Robin Pal is greatly appreciated. Also thanks to Rick Lang and Jim Disalvo of the Federal Reserve Bank of Philadelphia, and to Allen Berger of the Board of Governors of the Federal Reserve System, for assistance with data. The first author thanks the Geewax-Terker Research Program in Financial Instruments and the National Science Foundation (#SES-86130) for research support. This paper was previously entitled "Loan Sales, Recourse, and Reputation: An Analysis of Secondary Loan Participations." An earlier version was presented at the 23rd Annual Conference on Bank Structure and Competition, sponsored by the Federal Reserve Bank of Chicago, May 1987.

ABSTRACT

The Loan Sales Market

Secondary loan participations, or loan sales, are a recent innovation in banking. In a secondary loan participation, or loan sale, a bank makes a loan and then sells the cash stream from the loan, without explicit contractual recourse, guarantee, insurance, or other credit enhancement, to a third party. Between the late 1970s and early 1988 this market grew from insignificant amounts to about $240 billion. In fact, in roughly the last four years the loans sales market has grown by 784 percent.

The development of the loan sales market is momentous. Bank loans hitherto were nonmarketable securities which could only be removed from the balance sheet by creating a contingent liability or by legally transferring the debtor-creditor relationship. Neither happened in significant volume. Whatever unique services were provided by banks, their production apparently required the bank to hold loans until maturity. Consequently, the recent practice of loan sales raises fundamental questions about the uniqueness of banks relative to markets as mechanisms for allocating capital. In particular, are banks continuing to perform unique services, such as enforcing loan covenants, or are these activities now performed by other economic agents, in markets? If banks are still performing these activities, what incentives to perform do they face if the loans can be sold without recourse?

This paper describes the evolution of the loans sales market and explains the legal, accounting, regulatory, and economic issues raised by its growth. We present the available quantitative evidence on the growth of the loan sales market, the identity of buyers and sellers, the types of loans sold, the characteristics of the participation contracts, and the prices of loans which were sold. Qualitatively, loan participations are distinguished contractually from other bank asset contracts both legally and economically. The various contracts are defined and their legal implications discussed. A set of stylized facts about loan sales contracts, based on a sample of blank secondary loan participation contracts (and associated contracts with the underlying borrower), collected from money center banks, is presented.

Finally, we briefly consider possible explanations for how loans can be sold now when this was not possible (in significant amounts) previously.

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I. Introduction

In the last decade the market for loans sales has evolved from essentially nothing to a volume of about $240 billion. In fact, from $26.7 billion of loans sales in the second quarter of 1983 to the first quarter of 1988 this market grew by 784 percent. In this essay we describe the evolution of this market and explain why it is a momentous development in the history of banking.

A secondary loan participation or loan sale is a contract which sells the cash stream from an underlying bank loan to a third party. The contract transfers no rights or obligations between the parties to the underlying loan contract, and explicitly provides for no recourse for the third party against the bank. The contract provides no guarantee of the value of the loan being sold and no insurance or other credit enhancement is involved. The buyer of the loan also has no recourse against the borrower.

In a loan sale the bank intermediates between the third party participation buyer and the underlying borrower in an apparently paradoxical way. The third party buyer appears to rely on the bank to accurately reveal credit risk assessments and to enforce loan covenants even though the bank, given the sale to the third party, has no incentive to perform on the original contract. Insofar as this paradox is real and the volume of loan sales large, this is a very significant development in commercial banking.

Hitherto bank loans were nonmarketable securities which were held by the bank until maturity, thus keeping the bank at risk for the life of the loan. Any rationale for the coexistence of banks and markets as channels for the savings-investment process requires that banks provide unique services which markets cannot provide. The guarantee to depositors that banks would perform these unique services took the form of banks' risking their equity during the

life of the loan. If loans can be sold without recourse, however, then either these unique services are no longer required for those loans, or there is some new mechanism for ensuring that banks will perform. In either case the development is important because it fundamentally changes the way in which bank services are provided.

Loan sales raise theoretical questions about bank uniqueness for economists, public policy questions about safety and soundness for regulators, and practical questions about competitive contract design for bankers. In order to begin to address any of these questions, however, some assessment of the volume of loan sales, the types of loans sold, the characteristics of market participants, etc., is needed. In other words, the development of the market needs to be empirically documented. In addition, the exact contract features need to be examined to assess the significance of the change. Qualitatively, what do these contracts look like? Is bank performance on the underlying contract somehow implicitly ensured?

In this essay we present and assess the available quantitative data on loan sales, and we discuss the legal, accounting, and regulatory issues. We summarize the common contractual features apparent from examining a sample of blank loan sales contracts collected from major banks. The major findings can be briefly summarized as follows:

(1) The volume of loans sold has grown explosively in the last five years from very small amounts to $236.3 billion in the first quarter of 1988.

(2) In roughly the last four years, the ratio of loan sales to outstanding commercial and industrial loans grew from five percent to 86 percent for the top 25 banks.

(3) Loan sales represent a net addition to the volume of marketable securities; they are not a substitute for commercial paper.

(4) Loans are almost always sold without recourse.

(5) Large banks are the dominant loan sellers, but the number of banks

selling loans is increasing.

(6) The largest loan buyers are foreign banks, but large U.S. banks are important buyers, and increasingly loans are being sold outside the banking system.

(7) Increasingly, the loans sold are loans to firms without access to the commercial paper market. In 1987 less than half the loans sold were obligations of investment-grade borrowers.

(8) Between one-third and one-half of the loans sold by large banks in the last few years were loans made to finance merge and acquisition activity by the borrower.

(9) The maturity of loan sales contracts has lengthened dramatically. In 1985 80 percent of loans sold had maturities of 90 days or less. By July 1987 over half the loans sold had maturities exceeding one year.

(10) Loan sales yields are higher than equivalent maturity commercial paper, holding the commercial paper rating of the borrower constant.

(11) Spreads between the yield paid by the borrower and the yield earned by the loan sales purchaser have declined.

(12) The loans which are sold, have been significantly restructured, eliminating explicit long-term relationships between banks and borrowers.

These findings characterize the opening of a new market and the transformation of the traditional bank lending market. As the loan sales market has evolved the volume has grown, spreads earned by selling banks have decreased, and buyers are increasingly outside the banking system. As the market has matured buyers have bought more and more loans of firms that are not publicly traded, and under loan sales contracts of longer and longer length. Since most of the loans sold are to firms without access to the commercial paper market, the loan sales market is not simply a substitute for commercial paper. It, perhaps, most closely resembles the junk bond market.

The opening of a new market is always important. But in this case there may be very dramatic implications. Banking is a regulated industry mostly because of problems emanating from the nonmarketability of bank assets.

Clearly, if bank loans can be sold, then a large number of regulatory and policy issues arise. These are briefly discussed in the final sections of the essay.

The paper proceeds as follows. Section II examines the data on the volume, distribution, prices, and other characteristics of loan sales contracts and the underlying loans. Section III provides more detail on the form of participation contracts and related legal, accounting, and regulatory issues. Section IV examines the challenges to bank structure that participations provide. Section V concludes.

II. Loan Sales and the Loan Sales Market

This section describes the market and its evolution. Beginning with some background, the quantitative significance of loan sales is then assessed. The identities of loan buyers and loan sellers are discussed next. The characteristics of the loans sold, the characteristics of loan sales contracts, and the prices of loans sold, follow in respective sub-sections. Finally, the one known default is described.

A. Background

Loan selling *per se* is not a new activity for commercial banks. Rather, it is a very old business, over a century old. While the market has evolved during this period, particularly the legal standing of loan participation contracts, prior to 1983 the amount of loans sold appears to have been small relative to recent activity.[1] Also, the motivation for selling loans or participations previously seems much different than the current motivation. Prior to the 1980s there are no data on the volume of sales under different types of loan sales contracts.

While data on the volume of participations prior to 1983 is sketchy it

seems clear that the amounts were relatively small. For a brief period the Federal Reserve System sporadically collected some data on loan sales in the 1970s. These data are shown in Table 1. The first column shows the amounts of loans sold within the banking system. The second column shows the amounts sold outside the banking system. The basic message of Table 1 is that the amounts of loans sold in the 1970s was very small. From November 1970 to February 1976 loan sales within the banking system grew by only 17 percent. The volume of loans sold outside the banking system basically didn't grow at all between late 1970 and mid 1974, the period for which the Federal Reserve reported data. Moreover, the volume of loans sold outside the banking system never exceeded $2 billion. Clearly, loan sales would not be particularly important had these trends continued. These trends did not continue.

Additional data comes from an American Bankers Association (ABA) survey which estimated total loan sales of $17.1 billion in 1977.[2] It is not clear what loan sales are included in the ABA survey. It appears that more than sales of participations are included because the amount of $17.1 billion in 1977 seems unusually large if the same sales are being measured by the ABA as by the Federal Reserve System in Table 1. Of the two numbers it seems harder to understand what the ABA was measuring. Similar data problems will initially occur in the later period which we will focus on. However, even if the ABA estimate was correct, the amounts of loans sold are miniscule compared to current figures.

Previous activity seems to have been mostly confined to sales within traditional correspondent networks, in particular, loans bought and sold due to overlines.[3] In a 1977 ABA survey of banks, 51 percent of the respondents reported that overline loans were 81-100 percent of their upstream portfolios. Seventy-five percent of the banks reported that overlines were

more prevalent than "liquidity-based" loan sales. Surveys done in the late 1970s show that in the correspondent banking network large majorities of correspondents sell loans or participations and participated in term loans originated by respondent banks.[4] There is no evidence of any significant volume of sales of loans other than through these traditional channels, and for traditional reasons. Significantly, of the $17.1 billion of loans sold in 1977 the ABA estimated that $11.2 billion was in the form of upstream participations, i.e., small banks selling participations to larger banks probably because of overlining.

As we discuss below, the recent rise in the volume of loan sales is not characterized by upstream sales. Rather the largest sellers, and many of the largest buyers, are large banks. Overlining no longer seems to be the primary, or even an important, motivation for loan selling. Many loans are sold outside the traditional correspondent networks, in particular, outside the banking system. The volume has increased dramatically.

B. The Volume of Loan Sales

The volume of loan sales has grown from an almost insignificant amount in the late 1970s to $236.3 billion in the first quarter of 1988, the latest date for which FDIC Call Report data are available. In 1983 the volume of loans sold was $26.7 billion. In other words, the volume of loans sold grew by 784 percent in four years. In this subsection we review the available data documenting this remarkable growth.

Data on the volume of loan sales are primarily from the government in the form of Call Report data and survey data from sporadic Senior Loan Officer Opinion Surveys on Bank Lending Practices, also called the Lending Practices Survey (LPS), conducted by the Board of Governors of the Federal Reserve System.[5] A third important data source is an industry newsletter, Asset Sales

Report, which began publication in the summer of 1987.[6] Some additional data, mostly casual, is also available. Finally, impressionistic observations can be made from interviews with bankers. We emphasize and mostly rely on the government data and the information from Asset Sales Report.

It is difficult to discuss the growth of the loan sales market with accuracy because of distortions in much of the available data, particularly early data. Data on the volume of loan sales began to be collected in 1983 and 1984, a few years after the market had grown large enough to attract the attention of bankers and bank regulators. In early data there was some ambiguity about exactly what constituted a loan sale. As explained in Section III, below, there are different types of loan sales contracts. The government data sources change the definition of what is reported. In this essay we focus on secondary loan participations, though there are some other types of loans sales contracts which are discussed subsequently. Secondary loan participations constitute the bulk of the market. In the data loan sales made with recourse and some other types of contracts were apparently counted in early surveys of loan sales volume.[7]

Another problem, especially with early reporting of loan sales volume, is that it was not always clear whether banks were reporting gross sales of participations or the outstanding stock of participated loans. This latter issue is particularly important since the June 1985 LPS reported that loans sold are most often short-term. About 80 percent had maturities of 90 days or less, and about one-third were overnight. Consequently, if gross sales are reported, the same loan, sold repeatedly by rolling over the loan sale, would be counted repeatedly.[8]

Table 2 reports the data from the FDIC Call Reports.[9] The Call Report data are gross sales and include total sales of participations of both

domestic commercial and industrial loans and certain other loans. The series begins in the second quarter of 1983. The table confirms the upward trend in loan sales with sales rising from $26.7 billion to $236.3 billion over the sample period. Also shown in Table 2 are the total sales of the largest twenty-five banks and the total sales of the largest fifty banks (where bank size is measured by total assets). The largest twenty-five banks account for the bulk of the market.

Some perspective on the importance of the loan sales market can be gained by examining the growth of loan sales relative to commercial paper. One common hypothesis suggests that loan sales are a substitute for commercial paper, but this turns out not to be true. Figure 1 plots the ratio of loan sales volume to the volume of commercial paper. Relative to the commercial paper market, the loan sales market is rapidly expanding. While the ratio has grown enormously, growth of the loan sales market has not come at the expense of the commercial paper market. This can be seen by examining Figure 2. The commercial paper market has continued to grow.

If growth in the loan sales market is not coming at the expense of commercial paper, where is it coming from? Figure 3 plots the ratio of loan sales volume to the volume of C & I loans. The fraction of bank commercial and industrial loan partfolios which are being sold is growing enormously. Table 3 further demonstrates this enormous growth. Table 3 provides the quarterly outstanding loan sales volume as a percentage of total C & I loans for the top twenty-five selling banks since the second quarter of 1983. Remarkably, the percentage of the C & I loan portfolio which sold off by the top twenty five banks in early 1983 was less than five percent. By early 1988 this percentage was over 85 percent! Thus, the growth of loan sales volume has come about by making nonmarketable securities marketable.

Data from the Lending Practices Surveys, which inquired about loan sales four times between the fall of 1984 and the summer of 1987, confirm the upward trend in the volume of loans sold. Table 4 compiles the responses to survey inquiries. In the November 1984 LPS, respondents reported less than $5 billion in loan sales over the first half of the fourth quarter. In the June 1985 survey, the same banks reported $23.5 billion of sales during the first two thirds of the second quarter of 1985. According to the Federal Reserve System, however, the June data:

> . . . are not comparable to the data on participations that are collected on the Call Reports and may not be fully comparable to the data collected on the earlier LPS. In the case of the Call Reports...the Call Report data include sales of loans other than domestic C & I loans. Also, two respondents that reported large volumes of participations on the most recent Call Report were unable to provide the quantitative data requested in this survey. In the case of the earlier LPS, the instructions did not indicate clearly that gross sales of participations, rather than the outstanding stock of participated loans, should be reported. (June LPS, p. 3, footnote 1.)

In order to correct these problems and obtain more accurate estimates of the size of the loan sales markets, the February 1986 LPS asked respondent banks for information on the stock of domestic C & I loans they had originated and sold. The sixty large U.S. banks responded that at year-end 1985, they had originated and sold $26 billion of domestic C & I loans. While it seems safe to say that this figure is a fairly accurate measure, it is difficult to compare it to the earlier LPS figures. The latest LPS survey, that of July 1987, reports that "this market continues to mushroom: as of March 31,1987, the outstanding volume of C & I loans sold by respondents stood at $39 billion, a 50 percent increase from the amount outstanding on December 31,1985." The LPS data, in summary, seem to impressionistically concur with the trend in the Call Report data.[10]

Asset Sales Report began collecting data on the volume of loan sales in

July 1987. From July 1987 through August 1988 three banks, Bankers Trust, Security Pacific, and Citicorp were surveyed. Thereafter, the number of banks in the survey expanded to the current sample of ten banks.[11] The data from the first year do not seem significantly different from the Call Report data for those three banks.

There are other, indirect, forms of evidence on the growth of the loan sales market. The LPS contains information on the number of banks (in the survey group) active in selling loans. The September 1984 LPS reported that 54 percent of the very large banks (those with assets exceeding $5 billion) and 36 percent of the remaining respondents reported that they had sold loans. In the November 1984 survey, the response was that 75 percent of the very large banks and 83 percent of the remainder had sold loans. In the July 1985 LPS, 92.3 percent of the very large banks and 85.7 percent of the remainder reported that they had sold loans. Finally, in the February 1986 LPS the numbers were 100 percent for both groups. The picture which emerges confirms the popular view that more and more large banks are becoming involved in loan sales.

Another indirect piece of evidence on the rise of the loan sales market is the rise of bank asset sales departments and related bank investments in sales forces, etc., to compete in this market. Aside from impressionistic data in the financial press, the February 1986 LPS attempted to determine whether banks were significantly modifying their behavior in response to this developing market. Banks in the survey group were asked what actions they had taken over the past year or two to facilitate the sale of participations in C & I loans to U.S. addressees. Tabe 5 contains their answers.

Table 5 reveals that banks have been busy modifying contract designs to facilitate sales, and have invested in larger sales forces to distribute the

participations. One-sixth of the respondents indicated they were modifying contract terms in the underlying commitment agreements to facilitate selling participations to maturity. Half the responding banks indicated they had offered more attractive pricing to borrowers in exchange for permission to sell participations in their loans. Also, the June 1985 LPS reports: "Interviews with several money center banks suggest that, within the last year, eight or ten large banks have devoted substantial resources to enlarging their capacity to originate loans for distribution via participations."

Again in the July 1987 LPS banks reported that they had taken actions to expand their loan sales forces. Most respondents reported that they had tailored their loans to make them more salable, and most had made efforts to standardize loan documentation. The survey asked: "In the past year or so, which of the following actions has your bank taken to promote its loan sales and participations? (More than one may apply.)" The responses of the surveyed banks are reported in the bottom half of Table 5.

It is worth emphasizing the number of banks which reported that they have been restructuring loans in order to sell them. As shown in Table 5, in the February 1986 LPS only five percent of all the respondents, and 22 percent of the nine largest banks, reported restructuring loan agreements. In the July 1987 LPS, the respective percentages of banks which had tailor made loans in order to sell them were 42.9 and 88.9. In Section III, below, such restructurings of the underlying loans are discussed. It turns out that these restructurings are of particular importance.

The overall picture which emerges from the direct data on loan sales volume and the indirect evidence discussed above is unambiguous: the loan sales market is exploding!

C. Buyers and Sellers

Who are the buyers and who are the sellers in the loan sales market? The answers are provided in Table 6. Table 6 reproduces data from the February 1986 LPS and from the July 1987 LPS.

First, consider the identity of the sellers. It is clear from the table that large banks are the dominant sellers. This was also clear in Table 2. According to the data in Table 6, the nine largest banks accounted for more than half of the total amount of loans sold. Table 7 shows the top 25 loan selling banks at the end of 1987. The amounts sold, total assets and loan sales as a percentage of total assets are shown. Except for Security Pacific, all the banks' loan sales constitute less than one percent on their total assets, though they represent an enormous percentage of total C & I loans (as seen above in Table 3).

While Table 6 reports results from a survey of only sixty banks, out of more than 14,000 domestic banks, the survey group contains most of the active sellers. The February 1986 LPS reports that: "Call Report data on gross loans sold (both domestic C & I and certain other loans) indicate that the survey respondents accounted for more than 70 percent of loans sold by domestic banks during the fourth quarter of 1985 and for virtually all the growth in this series since it began to expand rapidly in the fourth quarter of 1984". Again, this is also clear in Table 2.

The February 1986 LPS reports that each of the nine largest banks reported \$200 million or more in outstanding loans sold, and that several reported having sold \$1 billion or more. However, fourteen other money center and large regional banks each reported \$200 million or more in outstanding loans sold. Also, several of these banks reported amounts large or larger than many of the nine largest banks. These amounts represented substantial

increases over amounts reported in the November 1984 LPS. In that survey no respondents with assets of under $5 billion reported sales of more than $100 million. Moreover, most very large banks also had sales under $100 million.

Who are the buyers in the loan sales market? Rows two through six of Table 6 provide information on the identity of loan buyers. With observations at two points in time it is also possible to draw some inferences about the changing composition of the purchasing group. Three observations seem important. First, the largest group of purchasers is foreign banks. Second, loans are increasingly being sold outside the (world) banking system. And thirdly, large domestic banks, the major sellers of loans, are also an important buying group. Each of these observations is discussed in turn.

At the end of 1985 the largest buyers were domestic banks, accounting for more than half of the loans sold. Of the remainder, foreign banks were, by far, the largest buying group. However, by March 31,1987, foreign banks had become the largest buying group. According to the July 1987 LPS: "About 45 percent of the outstanding loans sold by nine money center banks as of March 31 were on the books of U.S. agencies and branches of foreign commercial banks; moreover, almost one-half of their remaining loans sold went to a group of 'other' purchasers, among the most important of which were foreign offices of foreign banks."

Sales of loans outside the banking system while small seem to be increasing. Rows five and six of Table 6 show that thrifts and other institutions bought about $1.6 billion, or about six percent of the total loan sales outstanding in December 31,1985. The February 1986 LPS reports, however, that: "...about one-third of the respondents reported sales to thrift institutions and a similar percentage reported sales to other financial and nonfinancial institutions." By March 31, 1987 five percent of outstanding

loans sold were held by nonfinancial corporations. Thrifts held a similar amount.

While sales to nonfinancial institutions have been relatively small so far, they have grown. These non-bank and non-thrift buyers are a diverse group. The February 1986 LPS asked: "If your bank reported purchases by entities other than commercial banks and thrift institutions, which types of institutions were the primary purchasers (more than one may apply)?" The answers are shown in Table 8. Over half the large banks sold loans to non-financial corporations.

The July 1987 LPS also reports answers to the question: "If you reported having loans sold to 'other'..., please rank the following by their importance as 'other' purchasers." No clear picture emerges from the ranking elicited. Mentioned as important were bank trust departments, insurance companies, mutual funds, and pension funds.

The final observation was that large banks, while selling many loans, are also buy many loans. This is apparent in Table 6. Large domestic banks bought around one fourth of the volume of outstanding loans sold at both points in time. More information on this is provided in Table 9 which lists the largest domestic bank buyers of loans at the end of 1987. Loans purchased are also shown as a percentage of total assets. This percentage ranges from a low of just under one percent to a high of 21.56 percent. Notably, many of the largest loan sellers are also loan buyers. This can be seen by comparing the banks listed in Table 9 with those listed in Table 7. As discussed below, this should not be too surprising since these banks may be diversifying their portfolios, originating only certain types of loans and then selling them and buying a diversified loan portfolio.

Tables 10 and 11 present more information on the identity of the loan

buyers. The data in these tables are from Lending Practices Surveys taken at three dates. The first date is prior to the first date in Table 6; the other three dates overlap with the dates of data in Table 6. The picture presented by Table 6 and the February 1986 LPS results, discussed above, differ to some extent from the images created by these earlier LPS surveys. The earliest survey eliciting information on purchasers was the November 1984 survey. At that time, domestic banks purchased 70 percent of the loans sold, and foreign-chartered banks bought almost all the rest. Of the 58 respondents, only two reported any sales to nondepository institutions, and only four reported sales to thrifts. The total sales to thrifts and nondepository institutions was only 2.3 percent of total sales, or about $100 million.

The striking feature in the June 1985 LPS results was that foreign banks had become the predominant purchasers of loans, buying $14.5 billion or about 60 percent of the total. The share of U.S.-chartered banks fell to about 25 percent, or $6.1 billion. In June 1985 nearly a third of the responding banks reported sales to parties other than domestic and foreign banks. In particular, according to the report:

> . . . nine reported sales to thrift institutions, eight reported sales to nonbank affiliates of their parent holding companies, and ten reported sales to other nondepository institutions. Of the total loans sold, 4.5 percent ($1 billion) were purchased by thrifts, 1.3 percent ($300 million) were purchased by nonbank affiliates, and 7.1 percent ($1.7 billion) by other nondepository institutions. (p. 3)

Also, according to the June 1985 LPS, about 64 percent of the loans sold by large banks to other domestic (U.S.-chartered) banks were bought by small banks.

To briefly summarize, loan sellers are the largest banks, but it appears that over time more banks are engaging in loan sales. Loan buyers have been a shifting group. While the proportion of loans purchased by domestic banks has

always been high, it seems to be shrinking. The share purchased by foreign banks has risen substantially, while the share purchased by nondepository institutions has risen slightly.

D. Characteristics of the Loans Sold

While there is little information on the purposes of the underlying loans which are sold, there is information on whether borrowers are publicly-traded corporations or not. This has changed as dramatically as market size. In particular, the share of outstanding loans sold that were obligations of investment grade borrowers has dropped significantly. Below we summarize the evidence from the Lending Practices Surveys on the quality and purposes of the loans sold. In addition, there is some information about the nature of the borrowers' loan contracts. Subsequent subsections discuss the maturity and prices of the participations.

When the loan sales market was in embryonic stages in the early 1980s, the loans sold, in general, were domestic C & I loans to investment-grade borrowers (BBB or better). Also, the maturity of participations was typically short (90 days or less, often overnight). A typical description of the loans sold in 1986 is provided by the Bankers Trust, Loan Participation Summary:

> The typical borrower profile is a U.S. corporation whose publicly traded debt securities are rated Baa or better, and whose commercial paper is rated A1/P1 or A2/P2. In addition, we have the ability to offer investors participations in quality unrated companies and non-U.S. corporate and sovereign credits. Loan maturities range from 1 to 360 days, with rates that compare favorably to alternative money market instruments.

Bankers Trust sample borrower list has companies from a variety of industries. The lists of companies were typically Fortune 500 firms. Bankers Trust also offered participations in the one to seven year maturity range. Other large loan sellers offered similar opportunities.

The LPS data confirm that in the early stages of the development of the loan sales market the loans sold were obligations of fairly well-known, publicly traded firms. According to the June 1985 LPS the loans sold were generally obligations of better than investment-grade borrowers. Respondents were queried about what percentage of the loans sold were obligations of firms that had access to commercial paper financing. The response was that 70 percent were loans to firms with access to the commercial market. Table 6, bottom line, reports that two-thirds of the loans sold (as of year-end December 31, 1985) were obligations of publicly rated, investment-grade borrowers.

The quality of the loans sold had changed by the July 1987 LPS, as shown in Table 6. By March 31,1987 the share of outstanding loans sold that were obligations of investment-grade borrowers had dropped to about 45 percent. It is clear from Table 6 that this decline is mostly due to the drop in the share of investment-grade loans sold by money center banks. Their share dropped from 80 percent to 50 percent. It appears that as the volume of loans sold increased, banks reduced the quality of the loans being sold, most likely because most of the investment-grade loans were already sold.

The reason for this decline in quality may be the development of the market, as discussed in Section IV. Another, not mutually exclusive explanation, may be a shift in the composition of the loans that banks were making. In particular, the March 1987 LPS reported that merger-related loans "apparently are a central instrument in the market for loan sales and participations, particularly at very large banks, where over one-third of all loans sold or participated in 1986 were merger-related." The other responding banks reported that less than 10 percent of the loans sold were merger-related. It is also reported that:

> Merger-related loans were a particularly important component of loan sales and participations at several of the money center banks that are very active in this market; at these banks, more than one-half of all loans sold or participated were merger-related. Also, merger-related loans have an average maturity of about three years though it is not clear that the longer loans are the ones which are sold.

The July 1987 LPS reports that:

> Over one-third of outstanding loans sold reported by respondent banks as of March 31 were made to finance mergers and acquisitions; at money center banks, M&A loans accounted for almost 40 percent of their outstandings...In light of evidence that M&A loans rose substantially as a percent of C&I loans <u>booked</u> at respondents during 1986, it seems likely that their share in loan sales increased as well." (Emphasis in original.)

Aside from the type of borrower, and the purpose of the loan, the loan contract itself may vary. While the contract may be straightforward, it may also be a revolving credit or a loan commitment. The July 1987 LPS reports that 74 percent of the respondents, and virtually all the money center banks, had sold unfunded portions of revolving credits that they had originated. (Fifty-eight percent of the respondents, and one third of the money center banks, reported purchasing unfunded portions of revolving credits originated by other banks.)

It appears that increasingly loans sold are loans that were been made under what is known as a <u>competitive bid option</u>. In such a competitive bidding arrangement, the borrower invites a group of participating banks to bid for all or part of its loan. The participating banks, larger banks, check with their distribution networks of smaller banks, foreign banks, pension funds, insurance companies, and so on. The participating banks then submit bids for all or part of the credit. The borrower is required to take the lowest bid. The winning bank then makes the loan and sells it in pieces to its distribution network. To successfully compete large banks must be able to

sell loans. The July 1987 LPS reports that most money center banks sold loans acquired under competitive bid options.

E. Characteristics of Loan Sales Contracts

The most striking development in loan sales contracts has been the increase in their length. The rise in volume and the decline in quality has been accompanied by increasingly longer maturity contracts. Yet, throughout the development of this market, most loan sales contracts still do not involve recourse.

In the early stages of the market the maturity of sale contracts was very short. The June 1985 LPS reports that of the loans sold, about a third were overnight loans and about 80 percent had maturities of 90 days or less.[12] However, in the July 1987 LPS over half of the outstanding loans sold at survey banks had maturities exceeding a year. The July 1987 LPS asked: "Roughly what was the distribution of [outstanding loans sold] by original maturity?" The elicited answers show that 21 percent of the (dollar volume of) loans sold were sold under contracts with maturities less than thirty days. For the nine money center banks the percentage was 24.9 percent. For all respondents 22.6 percent of the volume was sold under contracts with maturities between thrity days and one year; the remaining 56.4 percent was sold at maturities of greater than one year. For the nine money center banks the respective percentages for thirty days to one year and over one year, respectively, were 24.7 percent and 50.4 percent.

Asset Sales Report also provides data demonstrating that the proportion of loans sold which had long-term maturities is greater than short-term maturity loan sales. In September 1987 Asset Sales Report began differentiating between long and short maturity loan sales. The available data are presented in Table 12. Compared to the maturity structure reported

earlier, in 1985, the picture presented by Table 12 is quite dramatic.

The relationship between the maturity of the loan sales contract and the maturity of the borrower's loan is an important issue, as discussed in Section III. Selling loans in "strips," known as "loan stripping," is the practice of issuing loans sales contracts with shorter maturities than the underlying loan. The February 1986 LPS reported that the volume of stripping was nontrivial. About thirty percent of the respondents reported that they had sold strips. About fifteen percent of the responding banks reported that they had sold individual amortizations of an amortizing term loan.[13] For reasons explained in the next section, however, the practice of selling strips is declining.

The Lending Practices Surveys contain some important evidence about the nature of the participations contracts. The issue of recourse is important because in order for the loan to be completely removed from the balance sheet, i.e., there is no contingent liability, the terms of the participation must extend for the full maturity of the underlying commitment or loan. Most loans are sold with no recourse, but in the February 1986 LPS thirteen percent of the banks reported they had sold loans with a put option.[14] Later LPS surveys did not inquire about the fraction of loans sold with recourse. But the July 1987 LPS reported that less than ten percent of the respondents sold loans on assignment.[15]

Finally, the February 1986 LPS reports that 80 percent of the responding banks "seldom or never allow purchasers to resell loans to a third party."

F. The Pricing of Loan Sales

At least two question about loan sales prices are of interest: (1) what are the yields paid on loans sold relative to apparently similar instruments such as commercial paper?; and (2), what is the difference between yields paid

13.14.3

by the bank on the loan participations and the yields earned by the bank on the underlying loans? In other words, are loan buyers earning a premium over similar instruments, and are banks earning a spread between the loan made and the loan sold?

Information on loan sales prices comes from two sources. Asset Sales Report asked the banks it surveyed to report the mean yield on loans sold by rating of the company's commercial paper and by maturity. No price data were requested about loans sold which were the obligations of borrowers which had no access to the commercial paper market. Also, the July 1987 LPS asked a few questions about pricing. These data are summarized below.

Table 13 summarizes the data collected by Asset Sales Report on a weekly basis from late July 1987 to late August 1988. The table lists the mean yields over this sample period by maturity and commerical paper rating of the borrower. Also listed are the spreads of the yield on the loan sales over the yield on equivalent maturity commercial paper, by rating. The spread of the loan sale yield over the yield on equivalent maturity LIBOR is also given.

Table 13 shows that yields on loan sales are greater than yields on equivalent maturity commercial paper by ten to twenty-five basis points for high quality, and by twenty to forty basis points for the lower quality. Yields are less than LIBOR. The variation in the yields and spreads over the sample period is measured by the standard deviation. Also, Figure 4, Figure 5, and Figure 6 plot the spreads of loan sales yields over LIBOR at three different maturities. Unfortunately, the data series are not really long enough to see definite trends.

What is the spread between the yields paid by borrowers and the yields paid by banks to loan buyers? The July 1987 LPS asked respondents to report the typical spread earned on a loan sold, where the spread was "the difference

between the rate paid by the borrower and the return earned by the purchaser." In other words, no origination or other fees are included. The results were summarized as follows:

> The mean spread reported was 15 basis points per dollar of loans sold. The money center banks, likely because of the larger size of the loans they sell, and perhaps also because they face stiffer competition, earned a mean spread of around 13 basis points; this compares to 19 basis points earned by other respondents. Both groups of respondents reported that, on average, spreads have narrowed in the neighborhood of three basis points in the past year. These spreads on loan sales compare to the ten basis points that commercial paper dealers apparently earn fro underwriting and placing paper. These commercial paper dealer spreads also have been under downward pressure recently...

The LPS also reported average spreads on thirty day loan sales similar to those reported in Table 13.

The same spread, between the rate paid by the borrowers and the return earned by the purchaser, can be examined by comparing the rates earned on the loans sold, reported by Asset Sales Report, to bank loan rates paid by borrowers, collected in irregular surveys conducted by the Federal Reserve System (and reported in the Bulletin). The surveys reported average loan rates paid by borrowers on: (1) overnight loans; (2) loans with maturities of one month and under; and (3), loans with maturities of over one month but less than one year. Matching these rates with the Asset Sales Report maturities of five days, thirty days, and ninety days, respectively, spreads can be computed for the two dates, August 1987 and February 1988, at which the Federal Reserve survey data overlaps with the Asset Sales Report data. The resulting spreads for the very short maturity are: -0.815 and -0.875 for August 1987 and February 1988, respectively. For the middle maturity the spreads are: -0.84 and -1.2475, for the two respective dates. In the case of the longest maturity, the spreads are: -1.37 and -1.84, for the two dates respectively.[16] As expected these spreads are negative, implying that selling banks are earning money (aside from fees which may be involved).

Unfortunately, there are not enough observation to say anything about trends.

G. Defaults

Under a loan sales contract, loan buyers have no explicit recourse against the selling bank should the borrower default. A loan buyer also has no explicit recourse against the underlying borrower should that borrower default. The debtor-creditor relationship remains with the bank and the borrower. But, having sold the loan the orginating bank may face no incentive to act against a defaulting borrower (to renegotiate the loan, for example). The bank may behave differently than it would if the loan had not been sold, and the bank's equity still at risk. We discuss this in detail later since the incentives the bank faces when such a default occurs are at the heart of explaining the growth of the loan sales market. Here we describe the one failure which has happended to date.

In August 1986 Republic Health borrowed $265 million from a syndicate with Security Pacific as lead bank, and eight other lenders. Security Pacific sold part of its share of the loan. In July 1986 Republic Health stopped interest payments on the loan. According to Asset Sales Report, October 5,1987: "Sources have reported that SecPac officials have been accompanied by representatives of a participating bank at several of Republic's workout meetings. The development was notable because investors in participations are considered non-voting members of the lending group, and therefore have virtually no influence at workout meetings."

In the example, Security Pacific had not sold its entire share of the Republic loan and so continued to face incentives to act in the same way as if it had sold none of the loan. It remains to be seen what will happen when a borrower defaults and the originating bank has sold the entire loan.

H. Loan Sales and the Larger Context

The rise of the loan sales market should not be seen in isolation. Banking is experiencing other changes perhaps rooted in the same transformation of the underlying technology. Particular manifestations include the growth in off-balance sheet activity and asset securitization. If loan sales represent a new contract form embodying traditional bank services, then the growth of off-balance sheet activity may represent a related phenomenon. Examples of off-balance sheet activity include loan commitments, standby letters of credit, interest rate swaps, and financial futures.

While most of the off balance sheet activities have grown in volume none have grown as fast as loan sales. Standby letters of credit have not grown nearly as fast as loan sales, growing only 36 percent between December 1983 and December 1987, and having actually declined in volume since December 1985's peak of $156.8 billion.[17] Another off-balance sheet item, loan commitments, have a higher outstanding volume than loan sales, but also have not grown as fast. Commitments have increased from $431 billion in December 1983 to $612 billion in December 1987. Thus, loan sales stand out because of the explosive growth. Interest rate swaps, however, have grown very fast. The volume of swaps surged from $186 billion in 1985 to $715 billion in December 1987.

III. Contract Form and Legal Issues

Secondary loan participations, whether they are straightforward sales, or in the form of "strips" or "bids," change the bank's asset-liability structure from the standard deposit-backed loan. Different forms of contracts control the relationship between the bank, the borrower, and the lender. The laws controlling each side of the participation differ from each other and from those governing standard loan contracts.[18] Furthermore, since laws and

regulations control the banks' ability to remove loans from the balance sheet, the contracting process and form inherently involves such considerations. These contractual features and their interpretations also determine bank incentives to maintain the value of loans and fulfill their fudiciary obligations. This section defines the different participation contracts and then reviews the legal, accounting, and regulatory aspects of these contracts.

A. Participations

Loan participations offer a major contrast with the traditional bank loan. In the standard case, the bank makes a loan, and thus has a claim on a firm. Funding comes from depositors, who then have a debt claim on the bank, which bears the credit risk. The generic participation, in contrast, puts the credit risk on the ultimate lender, the participation buyer. The bank makes a loan to the firm, which it sells, i.e., promises its payment stream to the buyer. Thus a contract between bank and buyer replaces the deposit contract, and though the bank remains responsible to the borrowing firm, and collects payments, oversees the collateral and enforces financial ratios, it passes the payments on to the buyer (who usually gets a copy of the original loan agreement). The buyer does not hold a claim against the bank.

Participations come in three basic types: assignments, novations, and participations.[19] These types differ in the degree to which they transfer rights and obligations. Assignments shift the direct debtor-creditor relationship from the bank to the loan buyer. They transfer the bank's rights to the buyer. The assignee gets rights not only to the payment stream, but some rights to take action directly against the borrowing firm. Still, an assignment does not pass on the bank's obligations towards the borrower (such as loan commitments) or any advantages potentially dependent on individual

bank characteristics (such as tax advantages). An assignment, thus, divides the original contract into two parts; no new contract is created. A novation completely transfers all rights and obligations of the bank to the participation buyer. The bank leaves the picture entirely, replaced by a new actor. Such a drastic shift needs the consent of the borrower unless otherwise explicitly written into the contract.

A participation gives the right to receive (in whole or part) future payments to be made according to the underlying loan contract. This is accomplished by creating a new contract. The participation contract exists only between the bank and the buyer, and thus the buyer has no rights against the firm, which may not even know a participation has been sold. Thus, a participation does not transfer any of the original rights and obligations of the original contract. The participation buyer must rely upon the bank to perform on the original contract, even though the bank may not now have any stake in the outcome. Should the firm enter bankruptcy, the original lender must file all claims. When the borrowing firm is notified that the loan has been sold, it is a disclosed participation, otherwise the participation is silent.

Banks have used participations for a long time, but the sort most prevalent now differs from the more traditional type.[20] The older sort of participation, sometimes better described as a syndication, usually involved a lead bank negotiating for other banks. The contract usually took the form of an assignment, though often each participating bank would make a separate loan to the firm, governed by the agreement negotiated by the lead. Sometimes the participants would lend directly to the lead bank, under a correspondent relationship. Often "overlining" motivated sales when lack of funds or lending limits precluded further lending.

Recent participations, or loan sales, appear to most commonly take the form of a straight sale of the cash flow emanating from a loan the bank has originated. Sales of short-term loans generally take the form of "bids" or "strips." Bids are short-term loan commitment lines (sometimes called uncommitted bid lines). When the firm takes down a short-term loan (three to 90 days) the bank sells the loan. Often banks enter competing bids on all or part of the loan, resulting in the competitive bid option discussed earlier. In some cases, the competition takes place via an explicit auction. Strips present a way to transform longer maturity loans into a series of more salable short maturity loans. Banks sell shorter maturity segments, or strips, of longer maturity loans. Recently, some competitive bid options also have taken the form of revolving credit agreements, with banks competing for each segment of the longer loan.

The participation agreement itself may be rather involved, so often partners use a master agreement, a document agreed to beforehand, that governs the buyers and sellers of participations, both bids and strips. The disposition of any collateral depends on the specifics of the loan (sometimes the buyer must take steps to perfect, sometimes not), but this is rarely important. As noted above, the resale market for participations is thin. Some sales (mainly to subsidiaries) occur, but to avoid problems with the Glass-Steagall act, banks often insert clauses saying participations are not bought for resale purposes.

This simple description of the basic participation conceals some subtle contractual points. The seller (or lead bank), as lender of record, may have obligations to the participation buyer, in particular to oversee the loan: collecting and distributing payments, monitoring collateral and financial ratios, enforcing loan covenants, and holding copies of the relevant

documents. But these obligations are usually implicit since participation contracts usually involve no recourse against the selling bank, and do not transfer rights against the underlying borrower. Reliance on the selling bank to perform can sometimes depend on the bank's still having a stake in the underlying loan, either because only part of the loan has been sold or because the maturity of the underlying loan is longer than the maturity of the participation. Thus, even if legally the bank need not perform, the incentives to maintain the value of the loan still exist if the bank's involvement with the customer is, in the above sense, larger than the participation.

B. Accounting Issues

Banks which sell loans obtain maximum benefit if they can remove the loans from their balance sheet, increasing their return on assets, return on equity, obtaining fee income and by-passing capital requirements. To do this, asset sales must meet two basic criteria: (i) the loan participation and the original loan must have substantially identical terms and conditions (except for a servicing fee retained by the seller); (ii) the loan participation must be without recourse to the transferor. The first criterion means, for example, that interest payments to the seller and the participant must occur at the same time, and a loan originally contracted on a fixed rate basis must be sold on a fixed rate basis. More importantly loans can only be removed from the balance sheet if sold to maturity, so banks must match the maturity of the participation to that of the loan.

These criteria are stronger than those suggested by the Financial Accounting Standards Board (FASB) in Circular 77. That allowed banks to count loans as off-balance-sheet if the bank sold control of benefits, could estimate its obligations under recourse, and could not repurchase the asset.

The Federal Regulatory Agencies, however, felt that recourse implied banks still bore credit risk for the asset and thus from a regulatory perspective had not shed the loan. Thus, since banks are subject to these stricter Regulatory Accounting Practices (RAP), only non-recourse loan sales leave the books. However, bank holding companies are subject to the FASB's Generally Accepted Accounting Practices (GAAP) and some loans with recourse will not appear on their balance sheet, even though they will appear on the balance sheet of the bank they own.[20]

For longer-term loans, the interpretation and application of the accounting principles presents few problems. For the strips and bids, however, where sales of a short-term loan under a long-term credit commitment takes place, questions have been more complex. In January 1988 the Federal Accounting Standards Board ruled that loan strips could be recorded as sales only if the buyer of the strip assumes the full risk of loss and the lender has no contractual obligation to repurchase the strip. Controversy over whether well most strips satisfied these requirements led to further conceptual refinement. Thus, the Emerging Issues Task Force of the American Institute of Certified Public Accounts allows the sale of a short-term loan under a long-term credit commitment to count as a sale if the commitment includes substantive covenants. The Board of Governors of the Federal Reserve System disagrees, and now forces banks to keep strips on their balance sheet for regulatory purposes. As the nature of the discussion involves the restructuring of bank loans to make them easier to sell, we provide more details in section E, below.

Banks can benefit from loan sales with recourse, especially if this creates a non-deposit liability not subject to reserve requirements. For example, the bank may sell loans without direct recourse, but hire an

insurance company to guarantee payments to the purchasers. The bank then reimburses the insurance company for any losses that incur. This contingent liability must appear on the books, but it is not a deposit, being only indirectly related to the loans.

Strips create their own set of problems. Because a loan must be sold to maturity in order to be removed from the balance sheet, selling pieces of a long-term loan will not do. Instead, as described below in more detail, a series of short-term loans is negotiatied to replace the single long-term loan or commitment. Each "advance" under the agreement is sold off to its full maturity (usually 90 days), meeting the regulatory requirements. Each advance must be a true refunding, so not only may interest rates change, but credit analysis may dictate that the loan not get renewed. Conversely, the borrower may discharge collateral at the end of each advance (though this may hurt the chances for renewal). As mentioned above, the bank must convince the borrowing firm that the advances are quite close to a long-term loan, but must also convince the regulators that each advance constitutes a separate agreement, with no commitment to continue lending.

C. Loan Sales and Securities Laws

Banks, already subject to several regulatory authorities, rarely seek further regulation. Yet to the extent that secondary participations are securities, an entirely different set of regulations applies.[21] As the loan sales market develops, the instruments begin to look at least superficially, like securities, and questions about the appropriate regulations become more common. The criteria for determining whether or not a participation is a security also introduces economic questions about the purpose and functions of banks in participations.

The relevant law defines securities quite broadly. The Securities Act of

1933 says that:

> . . . unless the context otherwise requires . . . the term security means any note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, reorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil gas, or other mineral rights, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities, including any interest therein or based on the value thereof, . . . or, in general, any interest or instrument commonly known as a "security" or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, a warrant or right to subscribe to, or purchase, any of the foregoing.

Any instrument deemed a "security" is then subject to the securities laws, which for a bank may prove disadvantageous. The Securities Act of 1933 requires issuers to register and disclose information about their security. The Security Exchange Act of 1934 provides for even stricter disclosure. The anti-fraud provisions of the 1933 Act and Section 10b-5 of the 1934 Act hold the issuer liable for fraud not only on factual misrepresentation (part of common law), but on factual omissions and half-truths as well. These statutes also make fraud easier to prove than under common law, dispensing with some concepts such as intent (or more technically, scienter). Finally, such cases may be tried in Federal court.[22]

Sellers of participations have two possible ways of exempting themselves from registration. The first uses the "private placement" exemption. Securities not offered to the public and sold only to sophisticated investors need not be registered, though they remain subject to the anti-fraud provisions. Another possible exemption, currently unlikely, is for securities of maturity under nine months. The courts have held that this applies only to commercial paper, but this may change as participations more closely resemble commercial paper.

A key question, if the growth of loan sales continues, is likely to be whether these contracts constitute legally defined securities. The courts have used four tests to decide if something is a security and thus subject to the security laws. These tests often hinge on the economic purpose of a transaction, raising economic questions and providing scope for policy advice. The basic test, known as the Howey/Forman test, considers the "economic realities" of the object involved and sets forth four criteria for a security. According to Scholl and Weaver (1982), "the Howey test defines a security as (1) the presence of an investment (2) in a common venture (3) premised on a reasonable expectation of profits (4) to be derived from the entrepreneurial or managerial efforts of others." On the surface, a loan participation appears to meet these criteria, but the words have acquired a legal meaning that in general excludes participations. Loans, being "non-speculative," do not count as an investment. Interest without capital appreciation does not count as profit. A bank's routine collection and overseeing duties do not count as managerial effort, especially if the participation buyer acquires rights to demand foreclosure or to veto changes in the loan terms.

Several other tests focus on different aspects of the Howey/Forman approach. The Commercial/Investment test starts from the premise that commercial loans are not under the jurisdiction of the securities laws, and so exempts anything that looks sufficiently similar. Since participated loans usually stem from a prior relationship with the bank, are used for working capital, pay a fixed interest rate and use standard bank forms, they fall into the commercial category. The Risk Capital test similarly asks whether the investment is used to finance "risk capital" on which the repayment will be very dependent on the firm's entrepreneurial efforts. Even though loans may

be risky, they have been judged to lack this speculative character. Finally, the Weaver test examines the context required by the securities laws and holds that activities sufficiently regulated and protected by banking laws and authorities do not need additional protection from the securities laws.

Overall, court cases have split on whether or not secondary loan participations are securities, with most of the recent cases upholding the banks' view. This may change as banks make more loans specifically with the intent of sale and otherwise introduce contracts that make the participations look more and more like securities. In the end, though, the costs of complying with security regulations may not be onerous, especially for the large banks who are the primary issuers, and the advantages of participations may make them profitable even if subject to SEC regulation. Furthermore, as participations look more like securities, the accounting standards for them converge toward the stricter requirements for securities. The Federal Accounting Standards Board has recently proposed increased disclosure about all financial instruments, requiring data on credit risk, future payments, interest exposure and estimated market value.[23] Though currently only a proposal (and one opposed by many banks) these tougher reporting requirements would decrease the paperwork advantage of participations.

D. Contract Structure and Language

Sample contracts obtained from money center banks confirm the points made earlier in this section. In this subsection these contracts are analyzed further. Some interesting details emerge in the areas of legal liability and recourse, information flow, and tailoring agreements for customers.

Buyers of participations might worry that since a bank has no stake in the loan sold, they will receive low quality loans or loans where the bank has not thoroughly researched the credit risk of the borrower. On the other hand,

banks must avoid recourse to get the loans off their balance sheet and claim exemption from the securities laws. Typically, the participation agreement states that "The Bank will exercise the same care in making and handling each Loan as the Bank exercises with respect to loans in which no participations are granted" but that "the Purchaser will make its own appraisal of the creditworthiness of each Borrower" and that the bank "shall have no responsibility with respect to, the solvency, financial condition, . . . or the validity and enforceability of the obligations of the Borrower," except for cases of willful misconduct or gross negligence.

The information flow created by contract provisions confirms the tension between recourse and quality. The bank "does not make any representations or warranties" about the loan or the borrower, but the bank does pass some information through to the participation buyer. Along with the obvious information about payments and liens on collateral securing the loan, the bank "will provide (or request that the Borrower will provide) to the Purchaser from time to time such financial and non-financial information . . . or on any related document bearing on the quality of such Loan." Often, the package sent with a Master Participation includes financial summaries (including, in some cases, information not publicly available) of corporations to which the bank anticipates making loans.

The selling bank:

> reserves the sole right and responsibility to enforce the obligations of the Borrower . . . and may, in its sole discretion, (a) agree to any modification of any of the terms of the Loans . . . (b) waive any such terms . . . (c) exercise or refrain from exercising, or waive, any rights or powers the Bank may have . . ."

Moreover, the bank "shall have no obligation to make any claim on, or assert any lien upon, or assert any setoff against, any property held by it . . ." In other words, the bank is <u>not legally bound</u> to protect the interests of the

participation buyer, either because these actions cannot be specified because they are too complicated, or because the bank does not want to be so encumbered. Indeed, rating agencies, like Moody's and Standard and Poor's, have begun to offer ratings on loans up for sale. This suggests that buyers desire more information than provided by the seller.[24] On top of all this,

> The Bank shall not, in the absence of gross negligence or willful misconduct, be under any liability to the Participant with respect to anything which it may do or refrain from doing which may seem to the Bank to be necessary or desirable. In general, without explicitly specifying the rights and duties in the participation contract, most claims by the buyer against the selling bank have not been recognized by the courts (Knight, 1987).

All the secondary participation contracts we examined contain features similar to those quoted above. Paradoxically, a market exists which at first glance looks like a "lemons market." The bank guarantees nothing; cannot be forced to act against the borrower; may, in fact, have no incentive to act in the absence of such obligations, and yet, provides no recourse. While these features are common, there are differences in how the underlying contract with the borrowers is being restructured to satisfy the restrictions required for removing the loans from the balance sheet. Banks are particularly sensitive about this because of competition, and we were less successful in obtaining information.

E. Restructuring Underlying Loans

The delicate issue of restructuring the underlying loan with the borrower is necessitated by the requirements for removing the loan from the balance sheet. Loans must be sold to maturity. In principle, this means that, for committed facilities, the loan advances must be sold out to the termination of the credit agreement. But, participation buyers typically want shorter maturities. The long loan can be restructured by defining maturity as

corresponding to the interest period. Thus, the long loan becomes a series of short loans. Practically, this means convincing the borrower to accept a sequence of short loans as being equivalent to a long loan, and convincing the participation buyer that the bank faces the right incentives to maintain the value of the loan because the bank has a long-term commitment, even if legally there only exists an implicit sequence of short-term commitments.

However, this arrangement requires the decision to refund to be nontrivial; it cannot be an automatic rollover. The underlying restructured agreement requires the borrower to satisfy certain conditions before the bank is obligated to advance new funds. If these conditions were not present, so that rollover was automatic, then the bank could be forced to lend at a time when the participant wanted to be paid off. For example, the participant might want out if there is a deterioration of the borrower's condition. In this scenario, the bank's funds would be used, in effect, to pay off the participant. The participant would have a put option, a kind of recourse.

In order to prevent such recourse, the decision to refund the loan must be nontrivial. If there is a deterioration of creditworthiness, then there must be conditions which would prevent the borrower from positively affirming the required clauses. The bank would then not be obligated to refund. The conditions spoken of above correspond to the loan covenants. As the quality of credit of the particular borrower lessens, from AAA downwards, more such restrictions or "triggers" are included.

How does this restructuring differ from the longer maturity agreement? The longer maturity agreement would have contained the same covenants and the same enforcement mechanism. That is, the takedown schedule would have been tied to performance of the covenants, explicitly or implicitly. Under the longer contract, the bank is committed for the life of the contract. Under

the sequence of shorter contracts, the same covenants must be enforced, in substantively the same way. Similarly, under both forms, the bank may have incentives to waive the restrictive covenants and continue funding even though adverse changes have occurred. A significant difference may occur if the lender's situation changes. Thus, buyers of strips are under no obligation to continue buying, and changes in interest rates, economic conditions, or portfolio decisions may lead them to quit part way through the revolving credit agreement. This would put the burden of loan takedowns squarely on the bank originating the strip. Without any material change in the borrower's status, it seems unlikely that the bank could refuse the loan, even though with a reduced distribution network it may wish to.

These potential liability funding risks for long-term commitments are at the root of claims that strips are not true sales. The Board of Governors of the Federal Resserve System has revised the Call Report, indicating that strips are not off-balance sheet, because it believes that the risk of having to refinance the loan creates recourse (even though the strips are made under a contract which explcicitly states that there is no recourse). Fear of regulation along these lines has stunted the strip market. Banks have switched to competitive bid options, which do not seem to have this implicit liability, though perhaps only because regulators have not had time to formulate a position.[25] The key question then is: to what extent is explicit maturity required to insure bank performance in a long-term relationship?

IV. Loan Sales and the Functions of Banking

Loan sales raise very basic issues about the purpose and uniqueness of banks, about the relations between banking and capital markets, and about the form that banking will take in the future. With loan sales it appears that banking is changing in a fundamental way. In this section we briefly discuss

the implications of loan sales for traditional banking roles and methods.

The existence of banks depends upon the banking industry playing a unique role in the savings-investment process that cannot be filled by markets. Recent theoretical work in banking identifies several unique services provided by banks. One explanation is that banks produce information and screen out borrowers with poor projects to prevent a "lemons market" problem. An alternative is that banks monitor borrowers by enforcing particular management actions and preventing other actions. In a securities market, no one person would want to bear the cost of producing information about prospective investments or the cost of monitoring the firm because all other investors would free-ride on their efforts. If information production or monitoring could be done privately then there would be needless, and costly, duplication. Banks arise then as information producers and as monitoring firms.[26]

An essential component of the rationales for bank existence concerns how bank depositors produce information about banks and how depositors monitor the actions of their banks. The depositors are assured of the bank's performance in producing information and monitoring projects because the bank owners, holding a junior claim on the value of the bank, profit only after the debt holders get paid.[27] This arrangement is credible only if the owners put up a sufficiently large equity stake as residual claimants. Notably these arguments require that the bank hold the loan until maturity because only in that way will bank equity be at risk, insuring production of accurate information and monitoring.

If banks could sell loans, then there would seem to be no reason for them to expend resources producing information and monitoring. These roles cannot be fulfilled by market participants, yet they buy the loans. Paradoxically,

loan buyers know that once the bank has sold the loan, the incentives for the bank to perform are no longer present (at least in the same way), yet they still buy the loans. Thus, loan sales appear to contradict the very essence of banking.

The growth of the loan sales market means either that there is a declining need for the special services provided by banks or that there is a new mechanism for insuring that banks provide such services. It may be that the costs to market participants of producing information and monitoring loans has fallen so much that there is no need for banks to provide these services at previous levels. Alternatively, it may be that banks are continuing to provide information production and monitoring services, but ensuring their performance no longer requires risking their equity by holding the loans until maturity. Which of these hypotheses is true was studied by Gorton and Pennacchi (1988).

Gorton and Pennacchi (1988) investigated whether the prices of loans sold contained a risk premium for the default of the selling bank. The basic idea was to test for the presence of implicit guarantees of the value of the loans sold by the selling banks. The possibility of implicit guarantees arises as follows. In order to avoid securities laws banks prohibit the resale of loan sales contracts.[28] Thus, there is no secondary market for loan participations. Since this makes loan sales contracts highly illiquid, banks informally offer to buy loans back before the maturity of the loan sales contract.[29] The question is whether this informal offer is essentially a put option provided to the loan buyer by the bank. If this put option exists then the bank's performance is ensured because there, in fact, exists a contingent liability associated with each loan sold.

If the put option exists, then loan buyers would be concerned with the

prospects that the loan selling bank might default. The put option would be priced to reflect such prospects. Consequently, when a loan is sold the presence of a risk premium for the default of the selling bank would be the price of such a put option. If no such risk premia exist, so that the default prospects of the selling bank are irrelevant and only the underlying borrower's default risk is priced, then loan buyers must be doing their own information production and monitoring. Gorton and Pennacchi find weak evidence of bank risk premia in loan sales prices, suggesting that banks are continuing to provide services which market participants cannot provide. The bank continues to perform these services because if it does not then the bank will be forced to buy the loan back.

While Gorton and Pennacchi found some evidence of the presence of implicit guarantees of bank performance, they did not explain what enforces this arrangement. Why does the bank abide by such an implicit arrangement, especially when the loan sale contract explicitly states that the buyer has no recourse? One answer is that the bank's reputation is at stake. Gorton and Haubrich (1988) investigate the development of reputations in the loans sales market as mechanisms for ensuring bank performance. The possibility of substituting a reputation for bank equity depends upon a technological change in the transmission of information.

Assuming that loan sales are feasible for some reason, another important question concerns why banks have only recently started to make implicitly guaranteed loans sales. Is the motivation due to changes in underlying information production and monitoring technologies which competition has forced banks to adopt? Or is the motivation due to regulatory changes. Or is the motivation some combination? Pennacchi (1988), Flannery (1988), Greenbaum and Thakor (1987), and James (1988) all present motives for loan sales. For

the most part the motives are regulatory based.

V. Conclusion

First, a parable from the dark ages of loan participations.

A big New York bank, it was said, held a one-million dollar participation on a loan to a lease broker. When the borrower failed to perform, the big New York bank sent someone down to Oklahoma City to find out what was going on. "What happened to the leases?" the banker asked. "I never bought'em," said the borrower.

"Wait a minute. What do you mean you never bought them? Our agreement with Penn Square says that that loan is secured by those leases, the unlimited personal guarantee of the borrower, and other personal property, including a 1980 Oldsmobile Toronado. What happened to your unlimited guarantee?"

"I'm broke."

"What happened to the money?"

"It got spent."

"'It got spent!' You mean to tell me I've got a million bucks tied up in a 1980 Toronado?"

"Hell, no. I sold that car last year. You haven't got a goddam thing." [Mark Singer, Funny Money, pp. 144-5.]

This story encapsulates many points about loan participations. The oil lease broker looks like a poor credit risk (it's doubtful he had access to the commercial paper market), and no one monitored his collateral. Despite these problems, Penn Square sold the loan upstream, meaning someone bought it. This admittedly extreme story illustrates the dangers of loan sales, namely, the seller can be selling overvalued loans to unsuspecting buyers. Presumably, this fear of buying "lemons" is one of the reasons that markets for bank loans did not develop earlier. But, when a market develops it means that such problems have been overcome. Some mechanism has arisen which allows buyers to reliably assess the quality of the sellers' product. Buyers avoid the lemons.

The loan sales market has grown to such an extent that it seems hard to

reconcile the fear of a lemons market with the existing reality of $240 billion of loan sales. Indeed, based soley on the observed growth to date, there seems no reason to believe that such growth could not continue, doubling in a short period of time. As the market has grown the loans being sold increasingly represent claims on assets which are harder to value because the underlying borrowers are not publicly traded companies. Also, as the market has grown maturities of loan sales contracts have increased. In other words, loan sales contracts have become increasingly risky. Intuitively, whenever any market develops it develops in this way. At first assets are sold which are not likely to be misvalued and then, increasingly, more complicated, riskier contracts are made. Unfortunately, this process is not well understood.

The implications of loan sales for banking are so far reaching that it is hard to predict the outcome until loan sales are understood better. Certainly, the very idea that bank loans could be sold in such quantities, under such contracts, and even outside the banking system, would have been inconceivable only a short time ago. The very idea contradicts the notion of a bank as an intermediary which creates securities and holds them until maturity as distinct from simply brokering claims issued by firms. Loan sales suggest that the ability of banks or other firms to produce information and monitor borrowers has changed. The link between the production of these services and the creation of a loan which must be held until maturity by the firm producing the services has, apparently, been severed, or at least altered fundamentally. At root, the technology for producing information and for monitoring has been transformed.

The marketability of bank loans has significant regulatory implications since the very conception of what constitutes a bank changes. Previously, a

bank was an institution which was essentially defined as a firm which financed nonmarketable loans with debt which could be "put" to the bank at any time. This combination created the historically incendiary possibility of banking panics since depositors could run the banking system and the banking system had no way to convince them of the value of its assets because the assets were not marketable. But, looking ahead, this would no longer be the case if loans can be sold in significant quantities. Since putable debt no longer would finance nonmarketable assets, the possibility of panics would be reduced if not eliminated. The very reason for deposit insurance and bank regulation would disappear.

There are also important implications for bankers. With a well-developed loan sales market banks can easily hold well-diversified portfolios, regardless of what comparative advantage they have in originating loans. Thus, it should not be a surprise that many of the largest loan sellers are also the largest loan buyers. Without such a market, small banks have limited prospects for creating diversified loan portfolios. Aside from the possibility of holding diversified portfolios of loans, banks' basic functioning changes with loan sales since such sales allow the return to banks from information production and monitoring to be separated from the actual security itself. Loans can be created and sold, earning a fee, without having to be held until maturity. For individual banks the strategic question arises of how best to facilitate this process.

A large number of questions remain at the loan sales market continues to evolve. What will bank contracts of the future look like? Will the contracts change as this market develops? Will the underlying contracts between banks and borrowers change further? Will secondary markets for loan sales contracts develop? Is it possible to sell all loans? If not, what are the limits of

the loan sales market?

FOOTNOTES

1 Knight (1987) provides background on the evolution of the legal status of loan participations.

2 The American Bankers Association survey is summarized in Banking, September 1978, pp. 49-57, and by Knight (1979). Also see Clark (1976) for an earlier survey.

3 A loan in excess of the bank's legal lending limit for an individual borrower is called an overline. The excess must be made in concert with other lenders through the participation process. The Garn-St. Germain Act raised the limit of total obligations of a single borrowing entity to a national banking association (with certain specified exceptions) from ten percent to fifteen percent of the sum of the banking association's unimpaired capital and unimpaired surplus. The total allowable lending to a single entity is further raised to 25 percent if the additional ten percent is fully secured by reaily marketable collateral for which a price quotation is readily available. State regulated banks face similar restrictions. An "upstream" participation occurs when a correspondent purchases part of a loan originated by a respondent. The term "correspondent" refers to a bank providing services for other banks, namely, smaller banks called respondents. "Downstream" participations are shares of loans originated by a correspondent and sold in part to the respondent.

4 In the 1977 American Bankers Association survey 76.2 percent of correspondents reported selling loans or participations to respondents, and 92.4 percent of correspondents reported participating in term loans originated by respondents. (See Knight (1979).) Similar activity was reported in a survey done two years earlier (see Clark (1976)). These surveys also indicate that sales of upstream and downstream participations were not viewed among the most important activities provided by the correspondent banking network.

5 There are sixty banks in the Lending Practices Survey. The respondents include the six largest banks in the New York Federal Reserve District, six large banks in the San Francisco district, three in the Minneapolis district, and five in each of the other nine districts.

6 Asset Sales Report is published weekly by the American Banker, One State Street Plaza, New York, New York 10004.

7 This ambiguity persists in the Lending Practices Survey (LPS) data. As explained in Section III, in the usual secondary loan participation or loan sale, the loan buyer contracts with the bank to receive a share of the principal and interest payments on the loan. The selling bank retains the creditor-debtor relationship with the borrower. Thus, if the underlying borrower defaults, the loan buyer must rely on the selling bank to arrange a possible loan workout. If a loan is sold under an assignment then the creditor-debtor relationship, originally between the bank and the borrower, is transferred. Under an assignment contract the creditor role is fully shifted to the loan buyer so that if the borrower fails, the loan buyer need not rely on the bank to deal with the problem. Sales under assignment contracts are counted in the LPS data. According to the July 24,1987 LPS survey: "The nine

money center banks reported that a bit under 10 percent of their outstanding loans sold were done on assignment."

8 As discussed below, this is no longer the maturity structure of the market.

9 In the Call Report data the observations for the first quarter of 1985 may be understated because of a change in the instructions for reporting sales of short-term revolving loans extended under written lines of credit. Beginning with the March 1985 Call Report, respondents were instructed to include the highest amount of such loans advanced and sold under each line during the quarter, rather than the sum of all such loans advanced and sold during the quarter.

10 The only other source of data on the growth of the loan sales market is a widely quoted New York Times article (by Eric Berg, January 20, 1986) which contains a table showing the amount of loans sold in 1983 to be $3 billion with five banks doing the selling; in 1984 the market is $10.5 billion with twelve banks doing the selling; and in 1985 the market is $18 billion with fifteen banks selling. It is not clear how these figures were arrived at and, in particular, whether they are somehow derived from government data. There are, also, other numbers scattered through the financial press, but they suffer from the same problem, namely, it is not clear how they were calculated or what they mean.

11 The other seven banks are Bank of America, Chase Manhattan, Chemical Bank, Continental Illinois, First National Bank of Chicago, Manufacturers Hanover Trust, and Toronto Dominion. In the Asset Sales Report survey banks report all participations of C & I loans sold without recourse, of all maturities, though only loans to North American borrowers. Credits sold on assignment are also reported, but primary loan distributions to syndicate members are not.

12 The wording of the LPS question seemed to imply that the maturity of the underlying loan and the maturity of the participation were identical. Since the maturities need not be the same it is not clear which maturity is being reported. In fact, as discussed in the next section, maturity stripping refers to the practice of selling a participation which is a claim on a borrower's drawing under a longer term commitment. Another possibility is that the participation is a claim on a loan where the underlying loan is a longer maturity.

13 Only one bank reported that it had separated interest and principal payments of a term loan and sold participations in individual payments.

14 The volume of loans sold with put options was not reported.

15 An assignment is a contract under which the debtor-creditor relationship is transferred.

16 In computing these spreads the Asset Sales Report data were averaged for the month. Only A1/P1 loan sales spreads were averaged.

17 The data are taken from the Call Reports schedule RC-L.

18 This section draws heavily on Kizzia (1987), Ryan (1984), Bray (1984),

Greene and Coles (1984), and Barmore (1986). Both contracts and their interpretations are in a state of rapid flux. The application of existing laws, regulations, and accounting standards to new instruments remains uncertain, while the experience prompts changes in the underlying laws and standards. For example, in 1986 the FASB started a major project addressing the issues of new instruments and off-balance sheet financing. See Knight, 1987, Swieringa, 1988.

[19] This follows the terminology of New York law, though English contracts and terms are similar. For more detail, compare Ryan (1984) with Hughes and Palache (1984). The English, for example, refer to a participation as a sub-participation.

[20] See Barmore (1986), Tompsett (1984), and Scholl and Weaver (1982).

[21] Additional information can be found in Melvin (1986), or Barmore (1986) which provide overviews of the legal issues.

[22] The question as to what constitutes a security has received much discussion in the legal literature. The most relevant treatments include Jurman (1976-77), Scholl and Weaver (1982), Green and Coles (1984), and M.A.L. (1978), all of which cite many specific cases.

[23] See Asset Sales Report, Dec. 7,1987.

[24] See Asset Sales Report, Jan. 11,1988.

[25] See Asset Sales Report, 1988.

[26] See Diamond (1984), Boyd and Prescott (1986), and Campbell and Kracaw (1980).

[27] In fact, this has never been rigorously shown. In Diamond (1984) and Boyd and Prescott (1986) the mechanism that ensures bank performance is the fact that the bank is fully diversified. The bank offers depositors a debt contract which can be paid off in full as long as the bank performs its tasks of monitoring or producing information. If the bank does not make good on promises to perform made to depositors, the depositors can detect this. Campbell and Kracaw (1980) do not rely on this mechanism to ensure bank performance, but instead rely on a contract which resembles equity in some respects.

[28] According to Asset Sales Report, September 19,1988: "As the market for trading commercial loans in the secondary market continues to mushroom, some selling banks are taking tough measures to control the activity and keep more of the business to themselves." Apparently, the problem is that some banks have been buying loans from other banks and then reselling them.

[29] In discussions with bankers, bankers at some banks readily concede that they informally offer to buy loans back, and, in fact, admit that many loans have been bought back. Bankers at other banks vehemently deny that they would buy loans back, and claim never to have bought a loan back..

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TABLE 1

Loans Sold Outright by Commercial Banks
($ billions)

Date	Loans sold to subsidiaries, foreign branches, holding companies, and other affiliates	Loans sold to all others except banks
Nov. 1970	$3.78	$1.82
Dec. 1970	3.17	1.85
Jan. 1971	2.71	1.91
Feb. 1971	2.66	1.90
Sept. 1971	2.90	1.60
Oct. 1971	2.85	1.58
Nov. 1971	2.85	1.59
Dec. 1971	2.85	1.62
Oct. 1972	2.22	1.73
Nov. 1972	2.43	1.74
Dec. 1972	2.60	1.78
Jan. 1973	2.70	1.78
Nov. 1973	4.33	1.81
Dec. 1973	4.35	1.80
Jan. 1974	4.44	1.80
Feb. 1974	4.81	1.48
Sept. 1974	5.30	NA
Oct. 1974	5.22	NA
Nov. 1974	5.08	NA
Dec. 1974	4.82	NA
Nov. 1975	4.73	NA
Dec. 1975	4.48	NA
Jan. 1976	4.36	NA
Feb. 1976	4.42	NA

Source: Federal Reserve Bulletin

NA -- Not Available

Loans Sold Outright by Commercial Banks (Amts. Outstanding; $ bil.) Amts. sold under repurchase agreement are excluded.

TABLE 2

Sales of Loan Participatrons by Federally-Insured Commercial Banks[1]
(Total transactions during the quarter, billions of dollars)

Date	All Banks	Top 25 Banks	Top 50 Banks	LPS Banks[2]
1983 Q2	26.7	12.5	14.5	12.7
Q3	26.8	12.1	13.4	13.8
Q4	29.1	11.4	12.5	16.8
1984 Q1	32.8	14.7	16.3	16.6
Q2	33.3	14.4	15.3	17.8
Q3	35.5	20.2	21.0	17.1
Q4	50.2	28.0	30.0	21.1
1985 Q1	54.6	32.9	33.8	21.1
Q2	59.9	39.6	40.5	NA
Q3	77.5	55.3	59.2	NA
Q4	75.7	51.2	54.0	NA
1986 Q1	65.4	43.1	45.8	NA
Q2	81.2	56.7	60.8	NA
Q3	91.3	64.9	69.6	NA
Q4	111.8	76.6	85.7	NA
1987 Q1	162.9	133.4	140.5	NA
Q2	195.2	165.7	170.0	NA
Q3	188.9	164.1	167.7	NA
Q4	198.0	170.9	174.4	NA
1988 Q1	236.3	210.1	214.9	NA

Source: FDIC Call Reports, Schedule L

NA--Not Available

[1]Sales reported are gross and exclude sales of consumer loans and mortgage loans. Also excluded are loans sold subject to repurchase agreements or with recourse to the seller. See the text for a discussion of changes in the definition of a loan participation and other reporting changes.

[2]There are sixty banks in the Lending Practices Survey. The respondents include the six largest banks in the New York Federal Reserve district, six large banks in the San Francisco district, three in the Minneapolis district, and five in each of the other nine districts. The volume of loan sales for the LPS banks was reported in the June 1985 LPS and was not updated because the bank names were not reported.

TABLE 3

Ratio of Loan Sales to Outstanding Commercial and Industrial Loans

Date	Ratio of Loan Sales to C & I Loans: Top 25 Banks	Top 50 Banks
1983 Q2	.0469	.0481
1983 Q3	.0458	.0448
1983 Q4	.0425	.0407
1984 Q1	.0535	.0519
1984 Q2	.0515	.0474
1984 Q3	.0736	.0663
1984 Q4	.1032	.0932
1985 Q1	.1233	.1079
1985 Q2	.1500	.1303
1985 Q3	.2077	.1889
1985 Q4	.1979	.1748
1986 Q1	.1669	.1487
1986 Q2	.2203	.1994
1986 Q3	.2577	.2315
1986 Q4	.2939	.2744
1987 Q1	.5332	.4671
1987 Q2	.6798	.5759
1987 Q3	.6728	.5641
1987 Q4	.6946	.5801
1988 Q1	.8571	.7053

Source: FDIC Call Reports

Table 4

Bank Lending Practices Survey: Loan Sellers

Approximately what has been the total dollar volume (in millions) of commercial and industrial loans originated by your bank that have been sold or participated to others thus far in the current calendar quarter?

November 1984 Survey

	0		1 - 100		101 - 200		201 - 300		> 300		Average	Total	Total
	Banks	Pct.	Banks	Pct.	Banks	Pct.	Banks	Pct.	Banks	Pct.	Volume	Volume	Banks
All Respondents	13	22.4	39	67.2	3	5.2	0	0.0	3	5.2	83.4	4,840	58
$5 bil. and over	8	24.2	19	57.6	3	9.1	0	0.0	3	9.1	121.2	4,000	33
Less than $5 bil.	5	20.0	20	80.0	0	0.0	0	0.0	0	0.0	33.6	840	25

June 1985 Survey

	0		1 - 100		101 - 200		201 - 300		> 300		Average	Total	Total
	Banks	Pct.	Banks	Pct.	Banks	Pct.	Banks	Pct.	Banks	Pct.	Volume	Volume	Banks
All Respondents	6	10.0	40	66.7	0	0.0	2	3.3	12	20.0	394.2	23,653	60
$5 bil. and over	3	7.7	23	59.0	0	0.0	1	2.6	12	30.8	579.7	22,610	39
Less than $5 bil.	3	14.3	17	81.0	0	0.0	1	4.8	0	0.0	49.7	1,043	21

February 1986 Survey[1]

	0		1-49 mil		50-99 mil		100-149 mil		150-199 mil		$ > = 200 mil		Total	Total
	Banks	Pct.	Banks	Pct.	Banks	Pct.	Banks	Pct.	Banks	Pct.	Banks	Pct.	Volume	Banks
All Respondents	0	0.0	14	23.3	9	15.0	8	13.3	6	10.0	23	38.3	26,061	60
Nine Largest Banks	0	0.0	0	0.0	0	0.0	0	0.0	0	0.0	9	100.0	14,691	9
Other	0	0.0	14	27.5	9	17.6	8	15.7	6	11.8	14	27.5	11,370	51

July 1987 Survey[2]

	0		0-100 mil		101-250 mil		251 - 500 mil		501 mil - 1 bil		Over 1 bil		Total	Total
	Banks	Pct.	Banks	Pct.	Banks	Pct.	Banks	Pct.	Banks	Pct.	Banks	Pct.	Volume	Banks
All Respondents	0	0.0	21	38.5	10	18.5	5	9.3	7	13.0	11	20.4	38.7	54
Nine Largest Banks	0	0.0	0	0.0	0	0.0	0	0.0	0	0.0	9	100.0	25.1	9
Other	0	0.0	21	46.7	10	22.2	5	11.1	7	15.6	2	4.4	13.5	45

Source: Senior Loan Officer Opinion Surveys on Bank Lending Practices

Notes to Table 2[1]

For the February 1986 LPS the question was phrased differently as explained in the main text. The question was: "As of December 31, 1985, approximately what was the outstanding amount of commercial and industrial loans to U.S. addresses that had been originated by your bank and then sold or participated to others? (Note: the information requested is different from that reported on the Call Reports, which request data on the gross amount of loans sold during the calendar quarter, without regard to repayments by borrowers, rather than the amount outstanding at the end of the quarter. Exclude loans that your bank retained on its books for purposes of the Call Reports, i.e., exclude 'sales' that are reported as borrowings on the Call Reports because your bank retains risk of loss from the loan under the terms of the transfer agreement. For example, exclude loans sold without recourse and loans sold subject to a repurchase agreement.)" (Emphasis in original.)

[2]The wording of the question again changed slightly.

TABLE 5

Actions Taken to Facilitate Loan Sales

February 1986 LPS

	Modified Revolvers		Restructured Amortizing Loans		Offered Concessions to Borrowers		Expanded Sales Force		Total Banks
	Banks	Pct.	Banks	Pct.	Banks	Pct.	Banks	Pct.	
All LPS Respondents	10	16.7	3	5.0	10	16.7	22	36.7	60
Nine Largest LPS Banks	7	77.8	2	22.2	7	77.8	9	100.00	9
Other LPS Banks	3	5.9	1	2.0	3	5.9	13	25.5	51

July 1987 LPS

	Expanded Number of Purchasers		Increased diversity of Purchases		Tailored loans to be more appealing	
	Banks	Pct.	Banks	Pct.	Banks	Pct.
All LPS Respondents	31	63.3%	29	59.2%	21	42.9%
Nine Largest LPS Banks	8	88.9	8	88.9	8	88.9
Other LPS Banks	25	57.5	21	52.5	13	32.5

	Sold Loans made under competitive bid options		Expanded Sales Force		Sought to standardize documents	
	Banks	Pct.	Banks	Pct.	Banks	Pct.
All LPS Respondents	19	38.8%	20	40.8%	23	46.9%
Nine Largest LPS Banks	7	77.7	9	100	8	88.9
Other LPS Banks	12	30.0	1	27.5	15	37.5

	Other		No Actions Reported		Total Banks
	Banks	Pct.	Banks	Pct.	
All LPS Respondents	3	6.1%	13	26.5	55
Nine Largest LPS Banks	1	11.1	0	0.0	9
Other LPS Banks	2	5.0	13	32.5	46

Source: LPS, February 1986 and July 1987.

TABLE 6

Sales of Participation in Domestic Commercial and Industrial Loans (LPS Banks)[1]
(Amounts outstanding in billions of dollars)

By Purchase	All Respondents[2]		Nine Largest Banks[3]		Other Banks	
	Dec. 31, 1985	Mar. 31, 1987	Dec. 31, 1985	Mar. 31, 1987	Dec. 31, 1985	Mar. 31, 1987
1) All Purchasers	$26.1	$38.7	$14.7	$25.1	$11.4	$13.5
2) Large Domestic Banks[4]	9.5	10.7	2.8	3.3	6.7	7.4
3) Small Domestic Banks[4]	3.3	2.7	.9	1.0	2.4	1.7
4) Foreign Banks	11.7	14.8	9.9	11.2	1.8	3.7
5) Thrifts	.9	1.8	.6	1.6	.2	.2
6) Non-Financial Corporations	NA	1.9	NA	1.9	NA	.1
7) All Others	.7	6.7	.4	6.1	.3	.6
Percentage of loans sold that were obligations of investment-grade borrowers	66.9%	45.8%	83.3%	52.9%	44.*%	35.6%

NA -- Not Available

[1]Respondents reported the total outstanding dollar amount of commercial and industrial loans that they had originated and sold or participated to others, along with a percentage distribution of sales to the five categories of purchasers. Dollar amounts for the categories of purchasers were obtained by multiplying the reported percentages by the total dollar amount of sales reported. Respondents were instructed to exclude loans that they retained on their books for purposes of the Call Report, i.e., sales with recourse.

[2]The respondents include the six largest banks in the New York Federal Reserve district, six large banks in the San Francisco district, three in the Minneapolis district, and five in each of the other nine districts. Two banks did not provide estimates of the share of loans sold that were obligations of investment-grade borrowers.

[3]Based on consolidated total assets at year-end 1985, these banks are Citibank, Bank of America, Chase Manhattan, Morgan Guaranty, Manufacturers Hanover, Chemical Bank, Bankers Trust, Security Pacific, and First National Bank of Chicago. This is a somewhat arbitrary grouping which has been used in other Federal reserve publications. Not all of these banks were among the nine most active sellers. The Federal Reserve System regards individual bank responses to this survey as confidential.

[4]For purposes of this survey, large banks were defined as those with $1 billion or more in total assets.

Source: February 1986 Senior Loan Officer Opinion Survey on Bank Lending Practices (reproduced verbatim).

TABLE 7

The Top 25 Largest Loan Sellers (1987)

BANK	LOAN SALES 1987-Q4 ($ millions)	TOTAL ASSETS (Dec. 31, 1987)	LOANS SOLD As % of Total Assets
CITIBANK NA	$14.31	$154.06	.0929
CHASE MANHATTAN BK NA	11.61	82.60	.1405
BANK OF AMERICA NT & SA	10.13	81.31	.0125
MORGAN GUARANTY TC of NY	12.19	67.00	.1819
MANUFACTURERS HANOVER TC	6.44	59.41	.1084
CHEMICAL BK	17.33	59.31	.2921
BANKERS TC	18.91	54.42	.3476
SECURITY PACIFIC NB	6.91	44.40	1.5552
WELLS FARGO BK NA	0.39	41.36	.0095
FIRST NB OF CHICAGO	6.59	35.48	.1858
CONTINENTAL IL NB & TC C	2.45	31.53	.0769
FIRST NB OF BOSTON	2.39	29.16	.0945
BANK OF NEW YORK	2.08	21.18	.0983
MELLON BK NA	2.12	21.05	.1007
MARINE MIDLAND BK NA	0.01	21.00	.0004
IRVING TC	0.14	20.50	.0066
FIRST INTERSTATE BK CA	0.33	19.60	.0170
FIRST REPUBLIC BK DALLAS NA	1.15	19.50	.0589
REPUBLIC NB OF NY	0.01	18.80	.0008
FIRST BK NA	0.03	17.87	.0019
FIRST UNION NB NC	0.005	16.17	.0031
NCNB NB OF NC	0.24	16.07	.0147
PITTSBURGH NB	0.22	15.77	.0137
NATIONAL BK OF DETROIT	0.74	14.89	.0499
BANK OF NEW ENGLAND NA	1.15	13.33	.0863

Source: FDIC, *Call Reports*

TABLE 8

Loan Buyers Other Than Banks and Thrifts

	Finance Companies		Insurance Companies		Pension Funds		Bank Trust Depts.		Mutual Non-financial Funds Corps.		Others			
	Banks	Pct.	Banks	Pct.	Banks	Pct.	Banks	Pct.	Banks	Pct.	Banks	Pct.	Banks	Pct.
All Respondents	11	18.3	5	8.3	1	1.7	2	3.3	2	3.3	7	11.7	4	6.7
Nine Largest Banks	1	11.1	1	11.1	0	0.0	1	11.1	0	0.0	5	55.6	0	0.0
Other	10	19.6	4	7.8	1	2.0	1	2.0	2	3.9	2	3.9	4	7.8

Source: LPS, February 1986

TABLE 9

The Top 25 Largest Loan Buyers Among U.S. Commercial Banks (1987)

Bank	Loans Purchased[1] 1987 Q4 ($ millions)	Total Assets (Dec. 31, 1987)	Loans Purchased As % of Total Assets
1) Bankers Trust Co., NY[2]	$514.2	$54,419.0	0.94
2) Morgan Bank (Del.)	469.3	3,012.6	15.58
3) Bankers Trust (Del.)[2]	464.1	2,152.5	21.56
4) First Republic Bank Dallas NA[2]	457.7	19,479.0	2.30
5) Morgan Guaranty Trust, NY[2]	335.4	67,002.7	0.50
6) Bank of New England NA[2]	308.4	13,327.6	2.31
7) Hibernia, New Orleans	292.6	4,799.1	6.10
8) Bank of Tokyo Trust, NY	263.6	6,406.8	4.11
9) MBank of Dallas NA	243.7	7,322.4	3.33
10) Union Planters, Memphis	210.5	2,279.9	9.23
11) Ameritrust Co., Cleveland	188.3	8,036.7	2.34
12) Pittsburgh National Bank[2]	171.3	15,765.2	1.09
13) Third National, Nashville	167.0	2,667.8	6.26
14) Manufacturers Hanover (Del.)[2]	166.9	1,926.3	8.66
15) First Interstate, L.A., CA[2]	165.0	19,604.1	0.84
16) United States Nat'l, Ore.	161.8	7,997.8	2.02
17) United Bank of Denver	154.8	2,615.3	5.92
18) First Nat'l, Louisville	147.1	4,093.1	3.59
19) First Fidelity, Newark	146.3	10,686.2	1.37
20) First Interstate, Phoenix	139.8	6,645.9	2.10
21) MBank Houston NA	132.1	4,853.2	2.72
22) Northern Trust Co.	131.6	7,690.0	1.71
23) NCNB of North Carolina[2]	131.1	16,069.4	0.82
24) First Interstate, Ore.	124.0	5,663.8	2.19
25) Bank of Hawaii	123.7	5,606.2	2.21

[1] Included are purchases of various kinds of commercial credits, such as Farm loans, interbank loans, and commercial real estate mortgages. Residential mortgages and consumer loans are excluded.

[2] Listed bank was also among the 25 largest loan sellers at the end of 1987. See Table 7.

Source: FDIC Call Reports, reported by Asset Sales Report, May 16, 1988, p.7.

Table 10

Bank Lending Practices Survey: Types of Buyers

To what types of institutions has your bank sold or participated commercial and industrial loans originated by your bank?

November 1984 Survey	Domestic Banks		Foreign Banks		Thrifts		Non-bank sub. of its bank or its holding co.		Unaffiliated Single Purpose Corporation		Other Institutions		Total Banks
	Banks	Pct.	Banks	Pct.	Banks	Pct.	Banks	Pct.	Banks	Pct.	Banks	Pct.	
All Respondents	43	95.6	10	22.2	4	8.9	0	0.0	0	0.0	2	4.4	45
$5 bil. and over	23	92.0	9	36.0	4	16.0	0	0.0	0	0.0	1	4.0	25
Less than $5 bil.	20	100.0	1	5.0	0	0.0	0	0.0	0	0.0	1	5.0	20
June 1985 Survey													
All Respondents	50	96.2	21	40.4	10	19.2	8	15.4	-	-	10	19.2	52
$5 bil. and over	32	94.1	19	55.9	10	29.4	7	20.6	-	-	10	29.4	34
Less than $5 bil.	18	100.0	2	11.1	0	0.0	1	5.6	-	-	0	0.0	18

February 1986 Survey

	Large Domestic Banks (> = $1 bil. assets)		Smaller Domestic Banks (< $1 bil. assets)		Foreign Banks		Thrifts		Other		Total Banks
	Banks	Pct.	Banks	Pct.	Banks	Pct.	Banks	Pct.	Banks	Pct.	
All Respondents	58	96.7	44	73.329	48.3	19	31.7	20	33.3	60	
Nine Largest Banks	9	100.0	5	55.6 9	100.0	6	66.6	5	55.6	9	
Other	49	96.1	39	76.520	39.2	13	25.5	15	29.4	51	

July 1987 Survey

	Large Domestic Banks (> $1 bil. assets)		Smaller Domestic Banks (< $1 bil. assets)		Foreign Banks[1]		Thrifts		Nonfinancial Corporations		Finance Company		Other		Total Banks
	Banks	Pct.[2]	Banks	Pct.[2]	Banks	Pct.[2]	Banks	Pct.[2]	Banks	Pct.[2]	Banks	Pct.[2]	Banks	Pct.[2]	
All Respondents	48	27.6	34	7.0	32	38.4	24	4.7	15	5.0	12	0.5	19	16.9	51
Nine Largest Banks	9	13.1	6	4.1	9	44.5	8	6.3	9	7.5	3	0.4	8	24.1	9
Other	39	54.5	28	12.3	23	27.0	16	1.6	6	0.5	9	0.6	11	3.4	42

[1] Includes domestic branches of foreign banks.

[2] The percentage is the mean percentage, i.e., weighted by the reported volumes.

Source: Senior Loan Officer Opinion Survey on Bank Lending Practices.

Table 11

Bank Lending Practices Survey: Amounts Purchased by Type of Buyer

Approximately how much of the total amount (in millions) of your sales and participations were purchased by:

November 1984 Survey

	Domestic Banks		Foreign Banks		Thrifts		Non-bank sub. of its bank or its holding co.		Unaffiliated Single Purpose Corporation		Other Institutions		Total Amount	Total Banks
	Amt.	Pct.	Amt.	Pct.	Amt.	Pct.	Amt.	Pct.	Amt.	Pct.	Amt.	Pct.		
All Respondents	3,417	72.1	1,217	25.7	62	1.3	0	0.0	0	0.0	47	1.0	4,740	-
$5 bil. and over	2,627	67.4	1,212	31.1	62	1.6	0	0.0	0	0.0	2	0.1	3,900	-
Less than $5 bil.	790	94.0	5	0.6	0	0.0	0	0.0	0	0.0	45	5.4	840	

June 1985 Survey

	Domestic Banks		Foreign Banks		Thrifts		Non-bank sub. of its bank or its holding co.		Unaffiliated Single Purpose Corporation		Other Institutions		Total Amount	Total Banks
	Amt.	Pct.	Amt.	Pct.	Amt.	Pct.	Amt.	Pct.	Amt.	Pct.	Amt.	Pct.		
All Respondents	6,126	25.9	14,476	1.2	1,064	4.5	307	1.3	-	-	1,679	7.1	23,653	52
$5 bil. and over	5,110	22.6	14,448	63.9	1,063	4.7	317	1.4	-	-	1,696	7.5	22,610	34
Less than $5 bil.	1,016	97.4	28	1.9	0	0.0	7	.7	-	-	0	0.0	1,043	18

February 1986 Survey

	Large Domestic Banks (> = $1 bil. assets)		Smaller Domestic Banks (< $1 bil. assets)		Foreign Banks		Thrifts		Other		Total	Total
	Amt.	Pct.	Amt.	Pct.	Amt.	Pct.	Amt.	Pct.	Amt.	Pct.	Amount	Banks
All Respondents	9,512	36.5	3,310	12.7	11,701	44.9	860	3.3	678	2.6	26,061	60
$5 bil. and over	2,806	19.1	896	6.1	9,916	67.5	646	4.4	426	2.9	14,691	9
Less than $5 bil.	6,708	59.0	2,410	21.2	1,762	15.5	216	1.9	262	2.3	11,370	51

July 1987 Survey

	Large Domestic Banks (> $1 bil. assets)		Smaller Domestic Banks (< $1 bil. assets)		Foreign Banks		Thrifts		Nonfinancial Corporations		Finance Companies		Other		Total Amt(bil)	Total Banks
	Amt. ($bil)	Pct.	Amt. ($bil)	Pct.	Amt. ($bil)	Pct.	Amt. ($bil)	Pct.	Amt. ($bil)	Pct.	Amt. ($bil)	Pct.	Amt. ($bil)	Pct.		
All Respondents	10.7	22.6	2.7	7.0	14.8	38.4	1.8	4.7	1.9	5.0	0.2	0.5	6.5	16.9	38.7	51
Nine Largest Banks	3.3	13.1	1.0	4.1	11.2	44.5	1.6	6.3	1.9	7.5	0.1	0.4	6.0	24.1	25.1	9
Other	7.4	54.5	1.7	12.3	3.7	27.0	0.2	1.6	0.1	0.5	0.1	0.6	.5	3.4	13.5	42

Source: Senior Loan Officer Opinion Surveys on Bank Lending Practices

TABLE 12
Maturities of Recent Loan Sales by Major Loan Sellers[1]
(Millions of dollars)

Date	Loan Sales[2] Short-Term	Long-Term	Total
Aug. 29, 1988	$16,427	$41,368	$57,795
Aug. 22	16,237	41,925	58,163
Aug. 15	16,094	41,872	57,967
Aug. 8	16,722	41,334	58,056
Aug. 1	15,950	41,104	56,984
Jul. 25	16,075	39,600	55,675

[1]The selling banks included are: Bank of America, Bankers Trust, Chase Manhattan, Chemical Bank, Citibank, Continental Illinois, First National Bank of Chicago, Manufacturers Hanover Trust, Security Pacific, and Toronto Dominion.

[2]Sales include all participation of C & I loans sold without recourse; only loans to North America borrowers; credits sold as assignment; no primary loan distribution to syndicate members.

[3]Short-term is defined as maturing in less than one year.

Source: Asset Sales Report, Sept. 6, 1988, p.2.

TABLE 13

The Pricing of Loan Sales

(Sales of Loans Made to Borrowers also Issuing Commercial Paper)

Loan Sales Yields and Spreads[1]	Borrower's Commercial Paper Rating					
	A1/P1 Maturity of Loan Sale			A2/P2 Maturity of Loan Sale		
	5 day	30 day	90 day	5 day	30 day	90 day
(1) Mean Yield	6.99	6.18	7.43	7.08	7.29	7.57
(2) Standard Deviation of (1)	0.38	0.47	0.53	0.38	0.48	0.53
(3) Spread to Commercial Paper (basis points)	10.89	12.59	24.52	20.37	24.35	37.72
(4) Standard Deviation of (3)	5.40	4.91	12.74	5.52	6.23	12.54
(5) Spread to LIBOR (basis points)	-11.11	-11.43	-2.11	-1.63	0.33	11.09
(6) Standard Deviation of (5)	56.70	8.65	17.36	56.40	7.98	16.61

[1]Yields and Spreads were calculated using weekly data from the sample period July 27, 1987 - August 29,1988.

Source: Asset Sales Report, various issues.

FIGURE 1

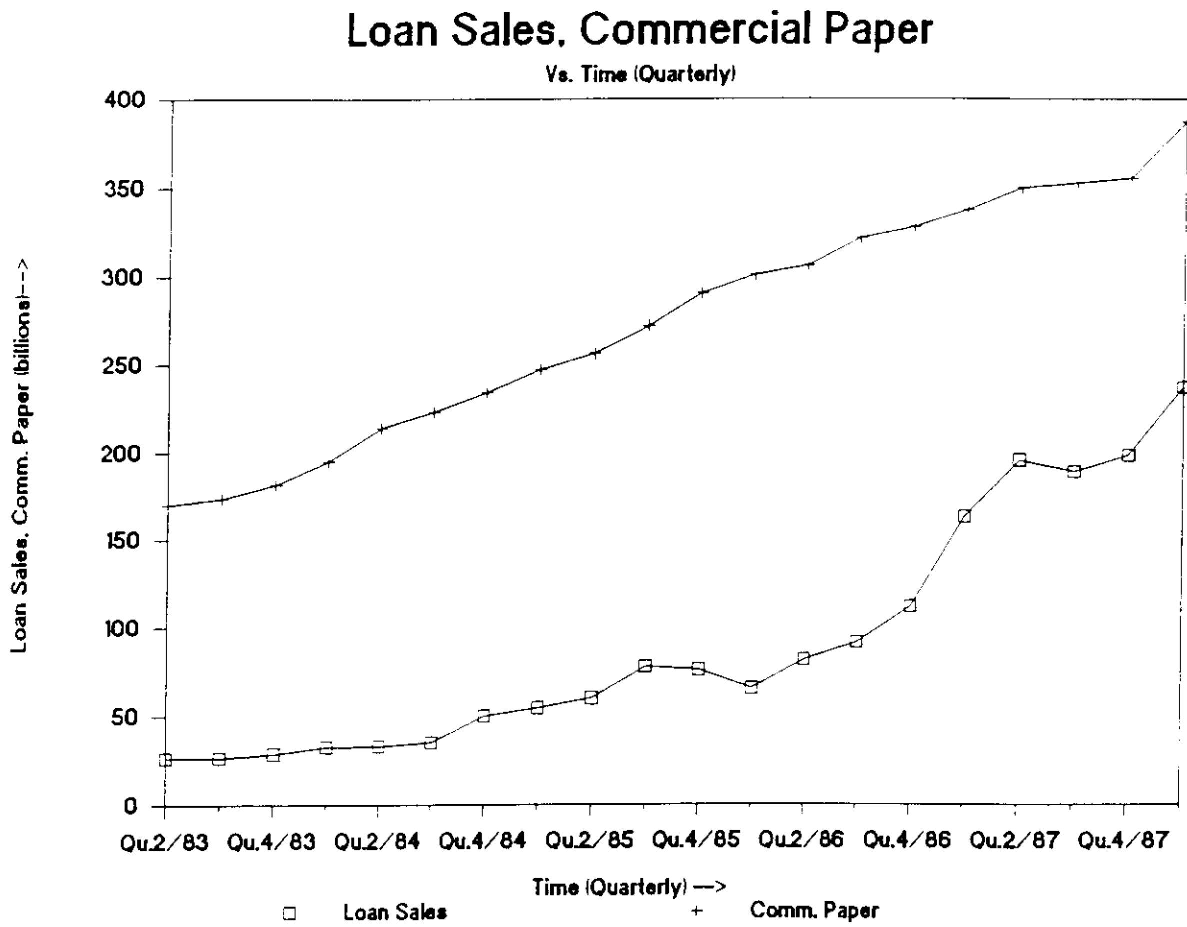

FIGURE 2

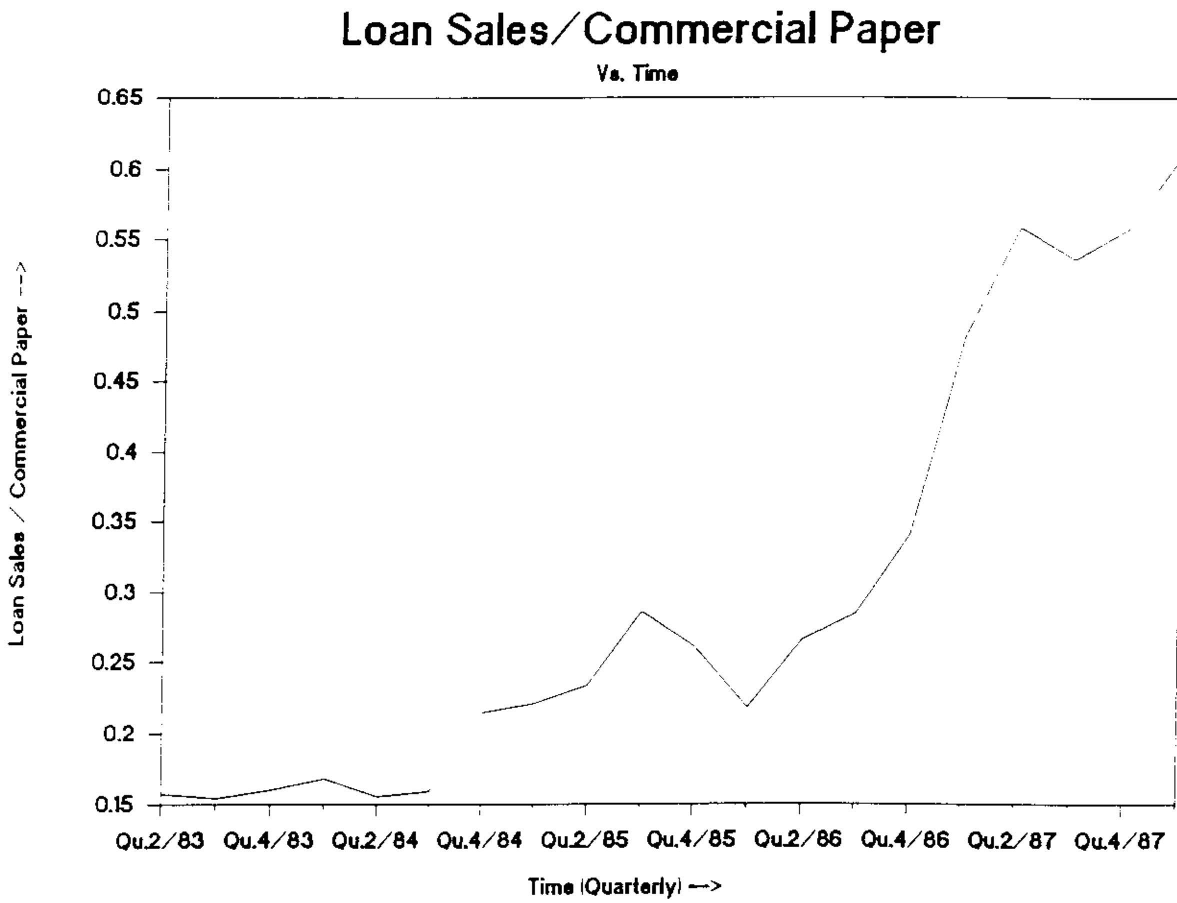

FIGURE 3

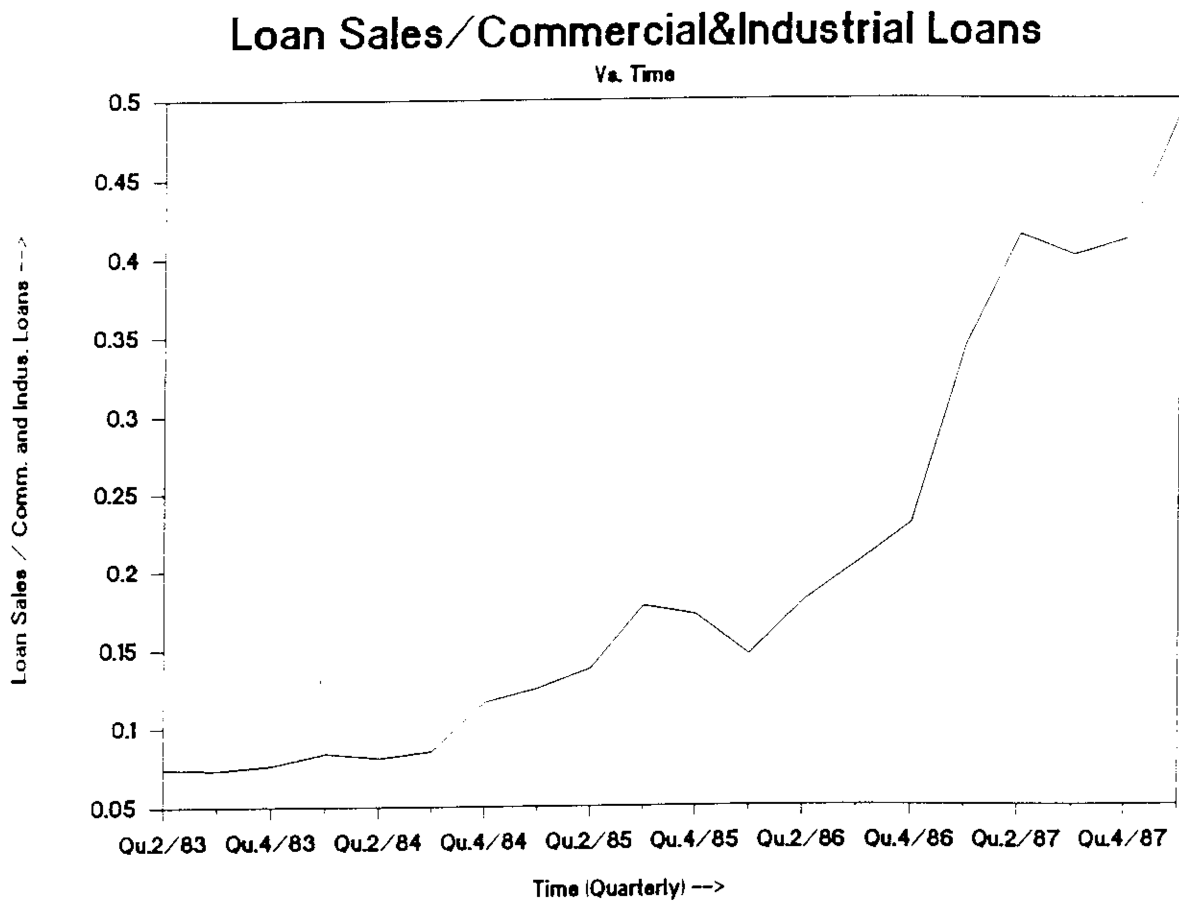

FIGURE 4

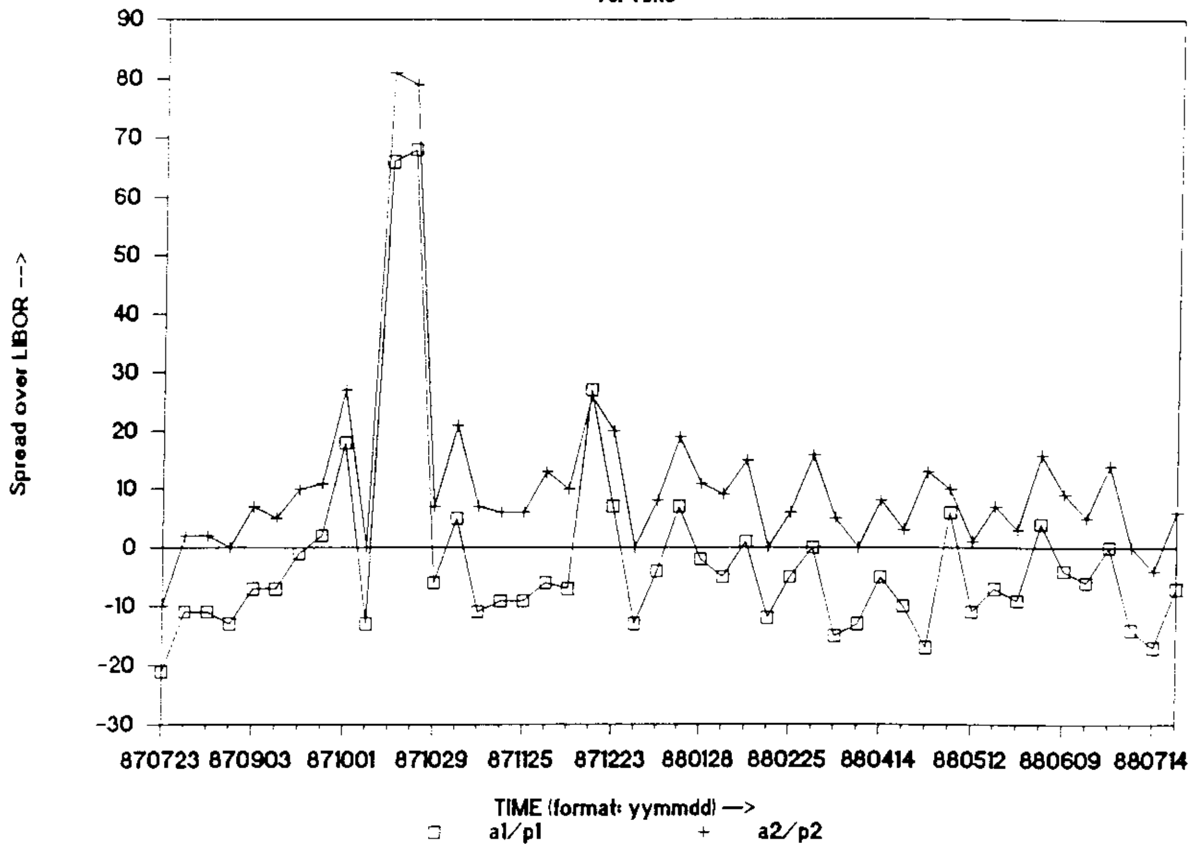

FIGURE 5

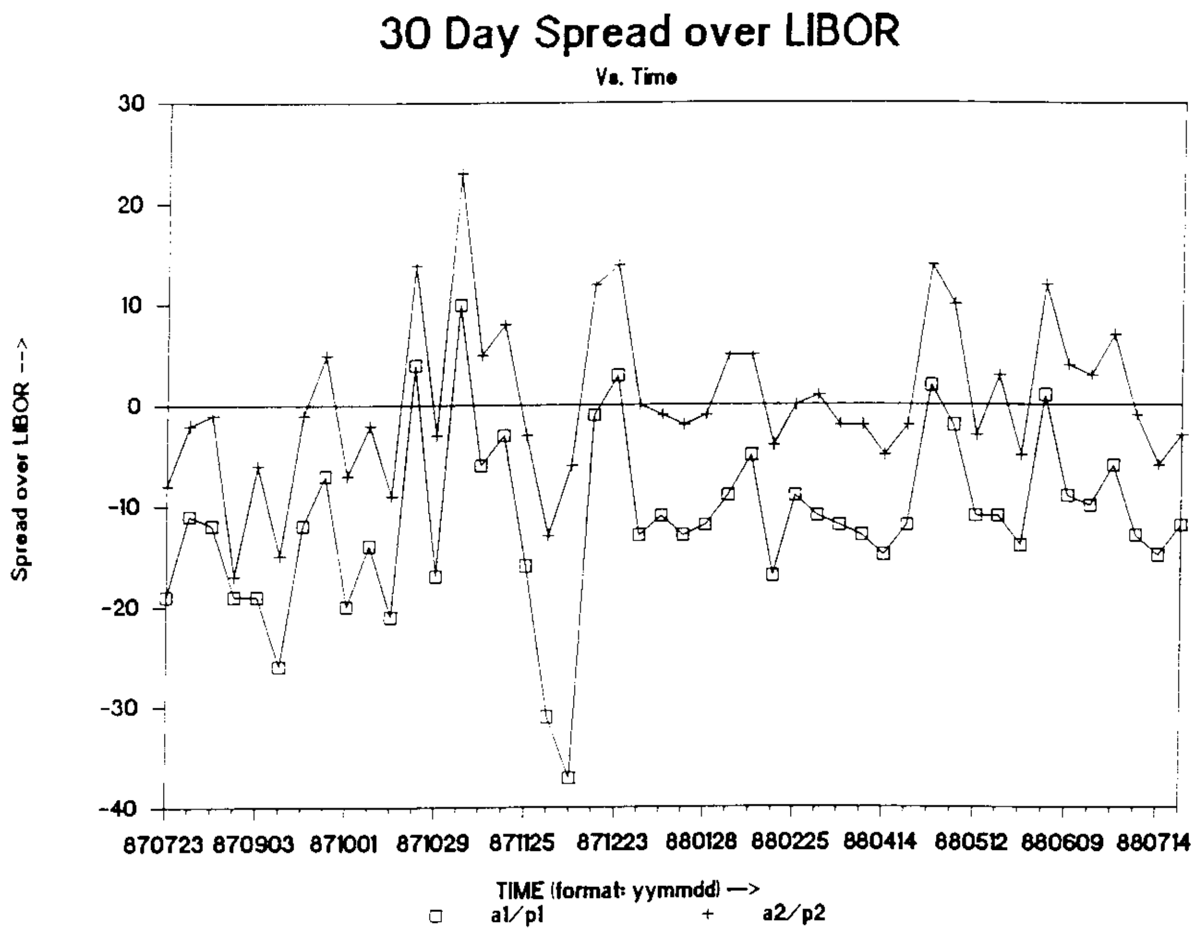

FIGURE 6