The Mercatus Center at George Mason University is an education, research, and outreach organization that works with scholars, policy experts, and government officials to bridge academic theory and real-world practice. The center’s Regulatory Studies Program works within the university setting to improve the state of knowledge and debate about regulations and their impact on society. More information about the center can be found on the Web at www.mercatus.org.

Private Securities Exchanges

Government deregulation may create benefits that manifest themselves long after a reform occurs because deregulation acts as a catalyst for innovation. The recent development of a private securities exchange spearheaded by several financial institutions shows that when deregulation is involved, unintended consequences are not necessarily a bad thing.

A cornerstone of U.S. securities regulation is that, pursuant to the Securities Act of 1933, any firm seeking to raise capital publicly by issuing securities must register with the Securities and Exchange Commission and file a prospectus containing detailed disclosures about the firm. Exceptions are made for “private placements” in which an issuer makes a limited offering of securities to only wealthy individual and institutional investors without the use of widespread advertising or anonymous solicitation. Purchasers of private securities not registered with the SEC are themselves prohibited from reselling without registering the securities or qualifying for a private placement or other registration exemption. Issuers of private securities must also take steps to ensure that the purchaser of such securities is not an underwriter — one who purchases securities with the intent to resell them.

To foreign companies wanting to raise capital from U.S. investors by issuing either equity or debt securities, the Securities Act’s regime of issuer registration, disclosure, and resale limitations can be unattractive. Rule 144A was adopted in 1990 by the SEC to attract foreign issuers to U.S. markets by establishing “a more liquid and efficient institutional resale market for unregistered securities.” Rule 144A permits holders of private securities to resell them without registering with the SEC, so long as (among other requirements) the buyer is a “qualified institutional buyer” (QIB). A QIB is a wealthy institution and includes employee benefit plans, insurance companies, and publicly registered investment companies owning at least $100 million in investments. In practice, both foreign and domestic issuers of securities utilize Rule 144A to raise capital privately in U.S. markets by first privately placing securities with
investment banks acting as underwriters who, in turn, sell to QIBs. Even though underwriters purchasing securities through a private placement have the intent to resell to QIBs, under Rule 144A they are not viewed as underwriters and therefore are able to resell to QIBs without registering the securities.

The goal of Rule 144A, as then-SEC chairman Richard C. Breeden noted, is to increase the liquidity and efficiency of the private placement market and expand the range of investment choices for U.S. institutional investors by giving them direct access to foreign issuers of securities. Judging by the amount of capital raised pursuant to 144A transactions, the 1990 reform was a remarkable success. Since its inception in 1990 and through 2006, the amount of equity and debt raised in 144A transactions expanded from $4.9 billion to $1 trillion. The year 2006 was the first year in which more capital was raised through 144A equity issues than on public U.S. exchanges, a development attributable in part to the decreasing competitiveness of the U.S. regulatory framework as a result of the passage of the Sarbanes-Oxley Act in 2002.

Notwithstanding the growth of the 144A securities market, its liquidity-enhancing function was undermined by a lack of organized exchanges for QIBs to trade 144A securities. However, in 2007, several large financial institutions established private electronic trading platforms as well. Among others, require much government information to be available publicly. Today, however, if information is available online, it is only nominally public. While agencies must publish proposed rules in the Federal Register (which is available online), the contents of rulemaking dockets, including public comments and ex parte letters, are not available online from many agencies. And when information is available online, it is often not offered in useful structured formats.

The New York Times website is a fairly typical state-of-the-art website. It presents all text in machine-readable HTML, which means that any browser can read it without needing to launch a second application and search engines can readily index the text. The site also provides its own search feature that allows one to search for keywords as well as limit the search to certain dates. Finally, the Times makes available hundreds of RSS feeds on just about every conceivable subject. Anyone can sub-

---

**Transparency**

If you have ever visited a regulatory agency’s website, you know there is much to be desired. There is neither the powerful simplicity of Google nor the robust diversity of a commercial database such as Lexis. Those firms strive to ensure that the user finds relevant information in the fewest possible steps. Agency websites, conversely, often seem to be an exercise in obscurantism.

Democracy is founded on the principle that the moral authority of government is derived from the consent of the governed. That consent is not very meaningful, however, unless it is informed. When government makes decisions in secret, the opportunity for corruption increases and government’s accountability to the people decreases. That is why we strive for transparency in government. When official meetings are open to citizens and the press, when government finances are open to public scrutiny, and when laws and the procedures for making them are open to discussion, the actions of government enjoy greater legitimacy.

The Administrative Procedure Act and the Freedom of Information Act, among others, require much government information to be available publicly. Today, however, if information is not available online, it is only nominally public. While agencies must publish proposed rules in the Federal Register (which is available online), the contents of rulemaking dockets, including public comments and ex parte letters, are not available online from many agencies. And when information is available online, it is often not offered in useful structured formats.

The New York Times website is a fairly typical state-of-the-art website. It presents all text in machine-readable HTML, which means that any browser can read it without needing to launch a second application and search engines can readily index the text. The site also provides its own search feature that allows one to search for keywords as well as limit the search to certain dates. Finally, the Times makes available hundreds of RSS feeds on just about every conceivable subject. Anyone can sub-
scribe to the feeds and be alerted to new content related to the chosen topic. Those remarkable but simple and common technologies are what make online information useful.

In contrast to the average commercial website or blog, there is the Federal Communications Commission website and its regulatory docket. The notices and comments that make up the bulk of its docket come into the world as digital text in word processing files, which means they can easily be converted to standard HTML. The FCC, however, tests the patience of its users by making them open files in Adobe Acrobat or Microsoft Word. Incredibly, there is no way to search the full text of dockets by keyword. Many documents are image files, not machine-readable text, and cannot be searched at all. RSS subscriptions to particular dockets (or anything else) are nowhere to be found.

Many agencies, like the FCC, manage their own online regulatory dockets. Others, however, have opted to house their dockets at the centralized Federal Docket Management System found at Regulations.gov. The site is described as “a groundbreaking achievement that puts Federal rulemakings open for comment at the American public’s fingertips.” However, it looks less like government boldly entering the 21st century than an attempt to drag the Internet back into the 1990s. The site lacks full-text search or structured feeds, and it is unclear which agencies are posting their complete dockets and which are not.

Regulatory agencies are not the only divisions of government plagued by inaccessible online data. Congressional information — such as voting records, the status of bills, and financial disclosure forms — are also difficult to ascertain from House and Senate websites. Some organizations, such as the Sunlight Foundation through its Open House Project, have been working diligently to reform official online resources. In the meantime, however, independent third parties have stepped into the breach. Where government has failed, private organizations offer citizens free access to public information in useful user-friendly formats.

For example, sites like the Washington Post’s “Congress Votes” database and GovTrack.us offer full-text search of all bills before Congress. Unlike the official sources, these sites offer sortable voting records to match the bills. They also offer RSS feeds for every bill and for each member of Congress, making it easy for anyone to track the status of legislation and the votes of particular legislators.

The Washington Post site also offers access to financial disclosure forms not available from any government site.

In essence, the sites send out computer “robots” to scour government webpages for information. They make sense of the data gathered and build their own databases of government data. The information is then made available to the public through simple but modern Web technologies, including search and RSS.

Perhaps more important than the access those sites facilitate, the structured feeds make possible other third-party applications. The applications often mix two or more feeds in innovative ways to produce new sources of data. For example, MAPLight.org combines feeds of congressional voting records with campaign finance data. Known as “mashups,” the programs have the potential to increase transparency by shedding light on previously obscure connections.

Agencies should be encouraged to reform their online offerings to match the basic standards of modern websites. A typical blog, after all, has searching, RSS, tagging, and many other up-to-date features built in. To the extent that agencies do not modernize, however, we should hope that private third parties build unofficial databases and make them available in a useful form to the public and to mashup artists.

— Mark Adams and Jerry Brito
Big Banks, Not Small Businesses, Benefit from the SBA

By Veronique de Rugy, Mercatus Center

C ongress created the Small Business Administration in 1953 in part to help small businesses borrow money. Proponents of the new agency argued that banks often failed to make loans to small businesses that, if given the loans, would prosper and contribute to economic growth.

Even if the lack of small business lending was a problem in 1953 (and that it not clear), the development of credit scoring models now gives small businesses access to capital even in the absence of collateral and extensive cash flow history. Yet, in fiscal year 2008, the SBA will guarantee $28 billion in loans. That is because the SBA serves two powerful constituencies: lawmakers who can sell the SBA as a program to help small business even though very few small businesses actually utilize the program (the SBA flagship 7(a) loan program represents roughly 1 percent of the number of outstanding small business loans) and the banking industry, which profits by issuing and selling the low-risk, government-guaranteed small business loans.

The SBA’s 7(a) loan program is intended to serve small business borrowers who cannot otherwise obtain financing from the private sector. The SBA does not provide loans directly; instead, after a business has proven that it can get a loan under “suitable” terms and conditions, it applies to an SBA-certified bank. In order to induce banks to extend the loan, the SBA guarantees the loan. If the borrower defaults, the SBA reimburses the lender up to 85 percent of the loss for loans of less than $150,000, and up to 75 percent for loans of more than $150,000. With such a guaranty, lenders are often willing to accept a greater credit risk and grant more favorable terms than they might otherwise.

BANKS BENEFIT Banks benefit from the SBA program in several ways. First, when a small business defaults on its obligation to repay an SBA loan, the bank does not bear most of the cost; taxpayers do. SBA data indicate that default rates can be as high as 16 percent. Thus, even though SBA borrowers are riskier than others, the downside risk to the bank is at most 25 percent of what it would be were the loan not guaranteed by the government. In some cases, the loan guaranty even makes the risk for banks lower for SBA loans than for traditional loans.

Second, under normal circumstances, banks would not issue loans to the small businesses in the 7(a) program because the high risk of default on the loans means that banks would not profit on the loans. But with the government guaranty, banks now can make a profit on SBA loans. According to David Bartram, chairman of the National Association of Government Guaranteed Lenders (NAGGL) and president of the SBA Division of US Bancorp, “We can be as profitable in a 7(a) loan program as we are in our conventional lending if done correctly.”

Third, through the SBA’s Secondary Market Program, lenders have another way to reduce their risk and increase their lending capability. Lenders pool the guaranteed portions of SBA loans and then sell trust certificates to investors that represent claims to the cash flows. In other words, the guaranteed portions of the loans are turned into tradable securities.

Generally, securitization involves grouping assets — such as residential mortgages or car loans — into large pools that are sold as securities to investors. The originator of the security will often offer loss protection to enhance the credit rating of the security. Lenders benefit from the increased liquidity and asset diversity, borrowers may benefit from lower financing costs, and investors benefit from greater liquidity and lower risk than if they had invested in the loans directly.

To encourage a secondary market, Congress passed the Small Business Secondary Market Improvement Act in 1984 to reduce regulatory barriers for the securitization of small business loans. Under the law, the SBA provides a secondary guaranty of the trust certificates, promising timely payments on the certificates if the borrowers’ payments are late. According to the Congressional Budget Office, through the Secondary Market Guarantee Program, the SBA is taking on risk in addition to the initial guaranty of payment of the principal and interest in the event that borrowers default and the agency purchases the loans. The additional guaranty makes the securities more valuable to investors, who are, as a result, willing to pay more for them.

Small business loans are typically not good candidates for securitization. Because the loans’ terms vary so much, their underwriting tends not to be standardized, and their risk requires such a high degree of credit enhancement, securitization becomes unprofitable. But SBA-guaranteed loans do not suffer those problems and most of the small business loans that have been securitized are SBA 7(a) guaranteed loans. From 1994 to 2001, over 40 percent of the guaranteed part of all 7(a) loans was securitized. By contrast, slightly less than 10 percent of the unguaranteed portion of 7(a) loans was securitized. The advantage of the SBA guaranteed loans is clear: between 1994 and 2001, almost $22 billion of SBA guaranteed loans were securitized while only about $4 billion of conventional small business loans were securitized.

This is done at low cost to lenders. Under current law, the SBA charges no fee for the 100 percent secondary market guaranty.
Only if the loan is sold for more than 110 percent of the outstanding principal balance is half of the excess paid to the SBA.

**PROFIT** The NAGGL website notes that “return on assets of SBA loans can easily exceed 5 percent, and return on equity can exceed 70 percent.” While return on assets is a poor measure of profitability, return on equity is not. Return on equity (RoE) reveals how much profit a company earned in comparison to the total amount of shareholder equity found on the balance sheet. A 70 percent RoE is remarkably high. As of January 8, 2007, the RoEs for the two biggest banks in America — Citigroup and Bank of America — were 18.36 percent and 16.56 percent respectively. Even the credit card company American Express, which enjoys a higher return because it requires fewer assets than commercial bank to conduct its business, has an RoE of 34.2 percent.

In a congressional hearing, NAGGL’s chairman explained that “if you were to sell the SBA guarantee portion, now you have only 25 percent of direct exposure on your bank’s books... so that is the reason why there is a leveraging power there. That is the reason why the loan can be profitable.” He also concluded that because of the federal guarantee, the SBA loan business is a higher-end business for lenders.

Who are the recipients of those sky-high returns? Reviewing a representative sample of 2,267 lenders, the FY2006 data show that the sample 7(a) lenders issued 97,290 loans for a total of $14.5 billion, of which the SBA guaranteed $10.2 billion or approximately 70 percent. The top 10 banks in the United States issued 51 percent of the 7(a) loans. Expand the list to the top 20 banks in the United States and the percentage rises to 65 percent. Bank of America leads the list of institutions. Others on the list are J.P. Morgan Chase, Wells Fargo & Co., and Capital Financial. The biggest banks in America are the ones benefiting the most from the SBA loan programs.

**ENTRY?** Economic theory tells us that if excess profits exist in a given market, new firms enter until profits are normal. If SBA loans produce high returns, more lenders should enter and the resulting competition should eliminate the exceptional returns. But if the return on equity remains high and there are no legal barriers to entry, profits must not be high enough to make entry cost effective for new banks.

There are about 6,000 banks and other lending institutions that serve millions of small businesses in the United States. According to the SBA’s Office of Lender Oversight, in 2006 there were 4,959 SBA lenders. However, according to the National Small Business Association, only 2,751 of those lenders originated at least one loan in 2006. Moreover, over half of the loans issued that year were issued by just 10 lenders, which means the other 2,741 lenders made very few loans.

According to SBA lenders, compliance requirements are complex and costly. Often, it is not cost effective for most banks to issue SBA loans even when they are lenders. For instance, large banks have enough resources to train and devote several full-time employees to SBA loan practices, but smaller banks cannot afford to do this and never develop the required expertise. Also, large banks have automated systems to meet SBA compliance requirements and have better and lower-cost credit scoring mechanisms in place. Smaller banks never or rarely issue SBA loans. The high cost of issuing SBA loans serves as a barrier to entry to the SBA lending market and shelters big banks from competition, which explains the recurring, high profit they make on SBA loans.

**PRIVATE PROFITS, PUBLIC LOSSES** Banks benefit, but taxpayers lose. Because the SBA guarantees such a high percentage of the loan amount, banks have little incentive to evaluate loan applicants thoroughly and the SBA applies little oversight. The SBA’s Office of the Inspector General (OIG) has repeatedly warned that the SBA needs to improve its oversight of lenders to minimize the risk of default, waste, and fraud. The OIG recently found that during the first half of FY 2006, 43 percent of SBA purchased guaranties were made inadequately. The OIG projects that SBA erroneously distributed $36 million in loans, a rate of about 17 percent.

The Government Accountability Office echoes those concerns, pointing out that if the economy were to plunge suddenly, 7(a) borrowers would increasingly default on their loans, forcing taxpayers to send large sums of money to the SBA banks. As of last year, the guaranties represent some $83 billion in potential taxpayer liabilities, a risk that banks would otherwise assume.

**CONCLUSION** Lawmakers sell the SBA loan program as a program that helps small business, an important and popular institution in the United States. In reality though, the SBA loan program is a form of corporate welfare for America’s biggest banks. The banks reap profits from the program, but the taxpayers have much to lose.