Recent Trends in Commercial Bank Loan Sales

by Rebecca Demsetz

Loan sales represent an important departure from the traditional bank activity of originating credit to be held until maturity. The dollar volume of commercial and industrial (C&I) loan sales rose rapidly in the mid-1980s but has declined equally rapidly over the past few years. Previous studies have discussed these aggregate trends;[1] however, aggregate data mask some interesting differences between the loan sales activities of the largest sellers and those of all other banks. This article seeks to provide insight into recent loan sales declines by examining the sales activities of two distinct groups of institutions. The first group includes the top few sellers only and is referred to as the market's "first tier." All other institutions are labeled "second tier."

The article finds that recent declines in loan sales appear to reflect a drop-off in the origination of loans likely to be traded in the secondary market, rather than a disruption of the secondary market process. Diminished origination of salable loans reduces the volume of "inputs" available for secondary market transactions. This pattern seems to have characterized the sales activities of both first-tier and second-tier banks. Second-tier sales first fell during the 1990-91 recession and have continued to decline with the persistent weakness of C&I lending since the recession. First-tier trends also reflect recession-related origination declines and the ongoing weakness in C&I lending, but appear to be driven mainly by a decrease in large credits related to corporate acquisitions, leveraged buyouts (LBOs), and recapitalization. The following three sections examine loan sales trends; the role of corporate acquisitions, LBOs, and recapitalization; and the importance of economic conditions.

Aggregate, first-tier, and second-tier sales trends

Chart 1 tracks the aggregate loan sales activity of all insured domestic commercial banks from the first quarter of 1986 through the first quarter of 1993. The data in Chart 1, drawn from banks' Reports of Income and Condition ("Call Reports"), measure the dollar volume of C&I loans originated and sold without recourse during each calendar quarter.[2] Quarterly loan sales flows attributable to insured domestic commercial banks peaked at $285 billion in 1989. By 1993, these flows had dropped to $89 billion, a decline of almost 70 percent.

The aggregate trends revealed in Chart 1 mask important differences in loan sales trends associated with first-tier and second-tier sellers. Chart 2 adds two additional series describing the loan sales activities of these subsets of the insured domestic commercial bank population. The first-tier subset includes the top five sellers in each quarter examined. All other banks belong to the second-tier subset. The size of the first-tier subset may seem arbitrarily small; however, loan sales attributable to the second five sellers are much smaller than those attributable to the top five sellers and follow trends similar to those experienced by the

[1] For example, see Joseph Haubrich and James Thomson, "The Evolving Loan Sales Market," Federal Reserve Bank of Cleveland *Economic Review*, July 1993; Richard Cantor and Rebecca Demsetz, "Securitization, Loan Sales, and the Credit Slowdown," Federal Reserve Bank of New York *Quarterly Review*, Summer 1993; and Allen Berger and Gregory Udell, "Securitization, Risk, and the Liquidity Problem in Banking," in Michael Klausner and Lawrence White, eds., *Structural Change in Banking* (Homewood, Ill.. Irwin Publishing, 1992), pp 227-91.

[2] The term "loans sold" refers to the sale of entire loans or portions of loans; "loans originated" refers to loans made directly by the reporting bank and does not include loans purchased from other institutions When a loan is sold "without recourse," the risk of the loan is transferred to the buyer.

remainder of the loan sales market.[3] Two first-tier sellers are especially important, accounting for an average of 42 percent of aggregate sales between first-quarter 1986 and first-quarter 1992.[4]

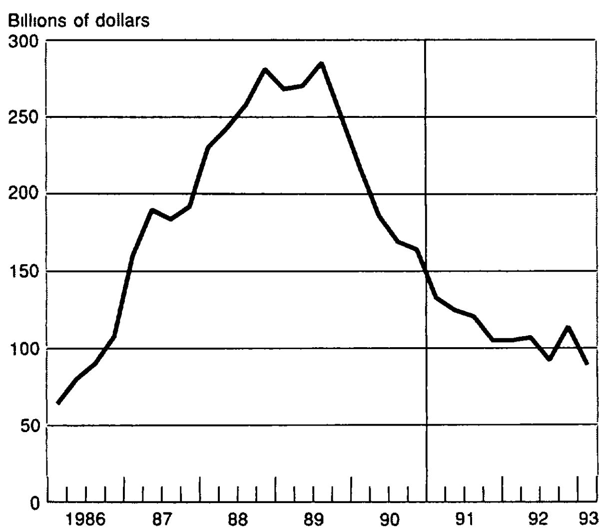
Chart 2 shows that first-tier banks, all very large institutions, account for a substantial fraction of both the level of aggregate sales and trends in aggregate sales Sales by first-tier banks increased rapidly through 1988, fell sharply from the third quarter of 1989 through the first quarter of 1990, and then fell more gradually over subsequent years These first-tier sales account for 81 percent of the aggregate loan sales increase between first-quarter 1986 and third-quarter 1989 and 80 percent of the subsequent loan sales decline Second-tier sales trends differ from first-tier trends but also show a rise and subsequent decline over the 1986-93 period Second-tier sales rose gradually in the mid-1980s, peaked in the first quarter of 1990 (after the peak in first-tier sales), and then fell at a rate similar to the rate of decline in loan sales by first-tier banks.

[3] In addition, the composition of the first-tier subset is quite stable over time A total of eight institutions appear in the seven first-tier subsets corresponding to the first quarters of 1986-92

[4] Berger and Udell first noted the importance of these two institutions, Security Pacific and Bankers Trust See "Securitization, Risk, and the Liquidity Problem in Banking "

Chart 1

Quarterly Sales of Commercial and Industrial Loans by Insured Domestic Commercial Banks: Aggregate Trends



Source Federal Financial Institutions Examination Council, Reports of Condition and Income

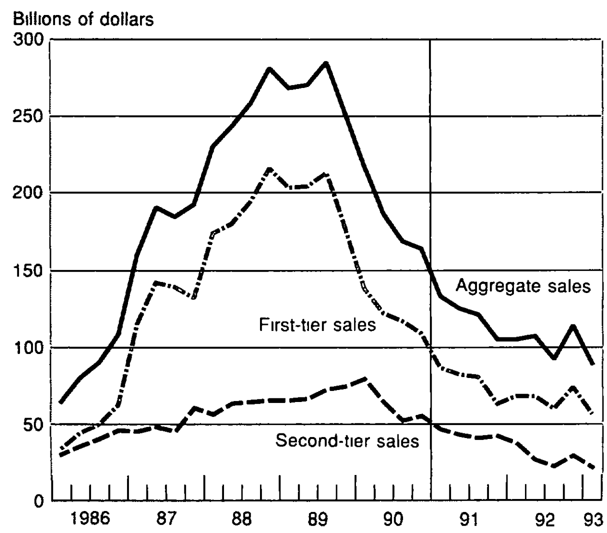
The role of corporate acquisitions, LBOs, and recapitalization

For first-tier banks, loan syndication activity provides insight into trends in the origination of salable loans Syndications are large credits shared by a group of banks upon origination. Since syndications are commonly parceled into smaller credits that are sold in the secondary market, syndicated loan volume gives some indication of the strength of secondary market loan supply by large sellers The table reports annual syndicated loan volume by purpose from 1987 through 1992 These data reflect lines of credit as well as actual loan originations, so they overestimate the volume of syndicated loans available for secondary market sale. Nevertheless, they do clarify the trends in the origination of salable loans by large banks

The table shows that total syndicated loan volume increased between 1987 and 1989 and then fell abruptly. Furthermore, the sharp drop in total syndicated loan volume was driven by loans in the "leverage" category. Syndicated loans extended for leverage purposes finance corporate acquisitions, LBOs, and recapitalization They are unlikely to represent lines of credit, because investment-grade borrowers generally use credit lines to support com-

Chart 2

Quarterly Sales of Commercial and Industrial Loans by Insured Domestic Commercial Banks: Subsample Trends



Source Federal Financial Institutions Examination Council, Reports of Condition and Income

Note "First-tier" banks are defined as the top five sellers in each quarter All other banks are defined as "second-tier " mercial paper issuance Data from the *Bank Loan Report,* a publication of *Investment Dealers Digest,* confirm a dramatic drop in syndications related to acquisitions, LBOs, and recapitalization between 1989 and 1990

Chart 3 compares trends in loan sales by first-tier sellers with trends in the volume of syndicated loans in the leverage category In the chart, loan sales are reported at quarterly intervals and syndicated loan volume is reported at annual intervals, so comparisons should be made with caution It is clear, however, that trends displayed by the two series are similar Several authors have noted a positive correlation between aggregate sales and corporate merger *activity.*[5] Chart 3 demonstrates a strong correlation between first-tier sales and *lending* related to acquisitions, LBOs, and recapitalization.[6] Conversations with market participants confirm the importance of these activities in explaining aggregate trends in the secondary market volume of top loan sellers In the future, the effect of such activities on the loan sales market will depend on the extent to which they involve bank financing.

Syndicated Loan Volume by Purpose

Billions of Dollars

Purpose	1987	1988	1989	1990	1991	1992
Leverage (acquisition, LBO, recapitalization)	66 1	162 7	186 5	57 9	20 9	39 9
Debt repayment	11 5	42 3	44 4	42 6	46 5	58 5
Specialty finance	17 0	8 6	7 1	17 4	16 6	23 0
General purpose	42 5	70 7	95 3	123 4	150 4	215 1
Total	137 1	284 4	333 2	241 3	234 4	336 5

Source Loan Pricing Corporation

The importance of economic conditions

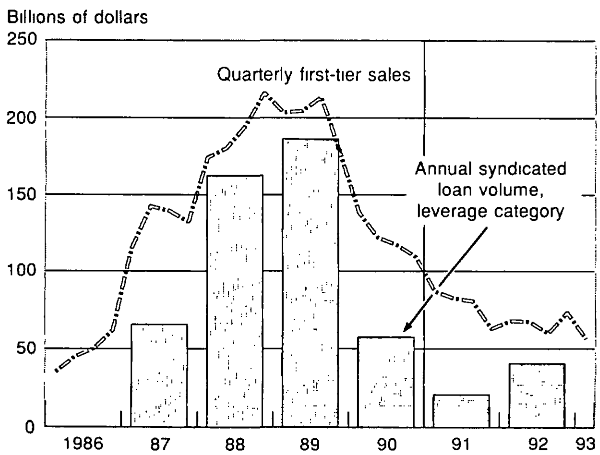
Trends in lending related to corporate acquisitions, LBOs, and recapitalization appear to be less important in explaining loan sales by second-tier banks, which continued to rise through the first quarter of 1990 The timing of the second-tier sales decline suggests that the recession-related slowdown in C&I loan origination was a key underlying factor As Chart 4 shows, a composite index of four coincident

[5] See, for example, Berger and Udell, "Securitization, Risk, and the Liquidity Problem in Banking," and Haubrich and Thomson, "The Evolving Loan Sales Market "

[6] Other authors have attempted to explore the relationship between bank loan sales and merger-related lending using Call Report data on "highly leveraged transactions," or "HLTs " (See Joseph Haubrich and James Thomson, "Loan Sales, Implicit Contracts, and Bank Structure," in *Proceedings from a Conference on Bank Structure and Competition,* Federal Reserve Bank of Chicago, 1993) The main drawback of these data is that they were introduced in the Call Report only after the dramatic declines in corporate merger activity and aggregate loan sales Other important limitations are that the HLT data measure the existing stock of highly leveraged transactions rather than the flow of new HLT originations and that all credits extended to an HLT borrower are considered HLT transactions, regardless of their particular purpose

Chart 3

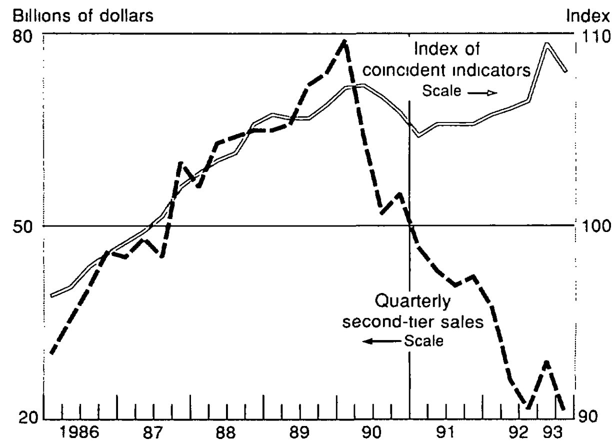
First-Tier Sales and Volume of Syndicated Loans in the Leverage Category



Sources Federal Financial Institutions Examination Council, Reports of Condition and Income, Loan Pricing Corporation

Chart 4

Second-Tier Sales and Index of Coincident Indicators



Sources Federal Financial Institutions Examination Council, Reports of Condition and Income, Survey of Current Business indicators of business conditions was highly correlated with second-tier sales from 1986 through the recent recession, peaking just one quarter after the peak in second-tier sales.[7] The correlation between second-tier sales and the index of coincident indicators weakened after the recession. Economic conditions improved, but loan sales by both second-tier and first-tier banks continued their decline. This divergence of trends may be attributable to the persistent weakness in borrowing by large corporations after the recent recession.

An econometric analysis confirms the importance of economic conditions and lending opportunities in explaining cross-sectional variation in loan sales activity.[8] This analysis divides the country into fourteen geographical regions and investigates the effects of regional economic conditions and a variety of bank characteristics on the loan sales activities of individual banks. Five of the geographical regions are identical to Census regions; the remaining four Census regions are divided into smaller geographical areas, with states that experienced similar economic circumstances over the relevant period grouped together. Variables used to measure economic conditions in each of the fourteen regions include the unemployment rate (a measure of current conditions) and consumer confidence (a measure of expected future conditions). Results of this empirical analysis suggest that regional economic conditions have been relatively important determinants of loan sales activity in recent years. In addition, the positive effect of economic conditions can be attributed, at least in part, to the relationship between economic conditions and loan origination opportunities.

Declines in the dollar volume of loan sales are consistent with either a drop in secondary market supply or a drop in secondary market demand. Price data can help determine whether the recession-related reduction in sales was supply- or demand-driven. Data from the *Asset Sales Report* of the *American Banker* magazine reveal that secondary market yields on C&I loans to investment grade borrowers fell relative to commercial paper yields during 1990 and 1991.[9] In conjunction with the decrease in loan sales volume over the same time period, this yield decline (price increase) suggests a drop in secondary market supply. Data from the Board of Governors' Senior Loan Officers Opinion Survey are consistent with this interpretation of secondary market dynamics in the early 1990s. The majority of banks included in the August 1992 and August 1993 surveys reported either increased demand or little change in demand by typical loan purchasers over the previous year.

In summary, while the initial decline in first-tier sales is associated with a sharp drop in lending to finance corporate acquisitions, LBOs, and recapitalization, the turning point for second-tier sales can be linked to recent cyclical slowdowns in C&I lending. The continued declines in both first-tier and second-tier sales since the recent recession have coincided with persistent weakness in C&I originations and the resulting reduction in secondary market supply. Together, these relationships suggest that recent drops in loan sales volume may be best explained by declines in the origination of salable loans.

[7] The four coincident indicators included in the composite index measure employment on nonagricultural payrolls, personal income less transfer payments, the index of industrial production, and manufacturing and trade sales. The composite index is available on a monthly basis from the Survey of Current Business Values reported are from March, June, September, and December

[8] See Rebecca Demsetz, "Economic Conditions, Lending Opportunities, and Loan Sales," Federal Reserve Bank of New York, working paper, 1994.

[9] Reported yields are on loans and commercial paper to borrowers rated A1 (Standard and Poor's)/P1 (Moody's) and borrowers rated A2/P2