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The SBA's 7(a) Loan Program

A Flexible Tool for Commercial Lenders

Abstract

This *Insights* report covers one of the largest federal loan guarantee programs, the Small Business Administration's (SBA's) 7(a) Loan Program. In fiscal year (FY) 2007, this program provided federal loan guarantees on approximately \$14.3 billion privately originated small business loans.¹ Lenders we interviewed for this report indicate that the 7(a) Loan Program is an attractive product because of its flexibility.² They note the use of the 7(a) program can help community and midsize banks develop new business, mitigate risk, enhance profitability, improve liquidity management, and meet certain regulatory requirements. The primary purpose of this report is to relay to bankers the potential benefits and risks of the 7(a) Loan Program.

The information presented was obtained from interviews with community and midsize national banks active in 7(a) lending, secondary market participants, trade associations, and SBA staff. Relevant reference materials, such as scholarly studies and newspaper articles, also were consulted. Appendix A provides a list of useful Web sites with additional information on the 7(a) program.

I. What Is the SBA 7(a) Loan Program?

The SBA 7(a) Loan Program was established by Congress in 1953. The program's mission is to help small businesses receive credit. The program provides loan originators a guaranty that if a loan defaults, the SBA will pay off a portion of the remaining balance. Lenders and the SBA share the risk at different levels. There are more than 5,000 lenders with outstanding 7(a) loans. Between 1997 and 2005, the program's guarantees have supported nearly \$87 billion in loans to small businesses.³ In terms of market share, 7(a) loans in 2005 amounted to 4 percent of all U.S. small business loans under \$1 million.⁴ Since 2002, the number of 7(a) loans has doubled, and in 2007 nearly 100,000 SBA-guaranteed loans were originated (see Figure 1). While the number of 7(a) loans has grown, the dollar volume has decreased slightly in recent years. In FY 2005 loan dollar volume stood at \$15.2 billion, and it declined to \$14.3 billion in FY 2007.⁵

¹ In FY 2008 the SBA has the authority to provide \$17.5 billion in 7(a) loan guarantees.

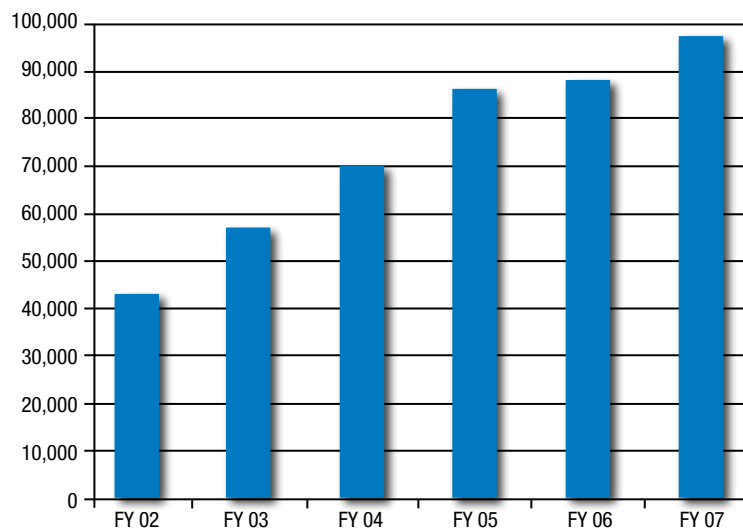
² The terms "lender" and "bank" are used interchangeably throughout the report.

³ The lending amount from 1997 to 2005 was reported in Rachel Brash and Megan Gallagher. *A Performance Analysis of SBA's Loan and Investment Programs*. The Urban Institute, Washington, D.C., 2008.

⁴ Government Accountability Office (GAO). *Small Business Administration: Additional Measures Needed to Assess 7(a) Loan Program's Performance*. Washington, D.C., 2007.

⁵ SBA data.

Figure 1. Total Number of 7(a) Loans Approved by Year



Source: SBA.

Under the broad label of the 7(a) program, there are several subprogram categories: the Standard 7(a), the *SBAExpress*, the *CommunityExpress*, the Patriot Express, CAP Lines, International Trade, and Export Working Capital have specific focuses (see Table 1).

Standard 7(a)

The Standard 7(a) is the base program. Standard 7(a) loans between \$150,001 and \$2 million are 75 percent guaranteed; those \$150,000 and under receive an 85 percent guarantee.⁶ Loans can be used for expansions and renovations; the purchase of land, buildings, equipment, and fixtures; leasehold improvements; working capital; refinance; seasonal lines of credit; and inventory purchase. In 2007, the Standard 7(a) program approved approximately 5,000 loans, and the average loan size was approximately \$400,000.⁷

SBAExpress

The *SBAExpress*, which has a revolving line of credit feature, is approved faster than the Standard 7(a) product because the SBA delegates the credit decisions to the lender.⁸ The quick turnaround time, however, comes with some limitations. The maximum loan amount is \$350,000, and the maximum guarantee is 50 percent. Terms for these loans are set according to the amount borrowed and are typically priced higher than Standard 7(a) loans. In 2007, this was the most widely originated 7(a) loan type, and it accounted for nearly 70 percent of the total number of 7(a) loans. The average *SBAExpress* loan was \$50,000.⁹

⁶ For small business commercial real estate credit needs that exceed the 7(a) loan maximum of \$2 million, the SBA 504 program might be a useful alternative. See Samuel Frumkin, "SBA 504 Loan Program: Small Businesses' Window to Wall Street," *Community Developments*, Office of the Comptroller of the Currency (OCC), 2006.

⁷ SBA data.

⁸ The Standard 7(a) does not permit revolving lines of credit.

⁹ SBA data.

CommunityExpress

The *CommunityExpress* product began in 1999 and was the result of a collaborative effort between the SBA and the National Community Reinvestment Coalition. This product, which has the same level of loan guarantee as the Standard program, is intended to provide revolving credit to potentially higher risk borrowers.¹⁰ Like *SBAExpress*, *CommunityExpress* has a quick application turnaround time, typically 36 hours.¹¹ Recently, the SBA committed to processing *CommunityExpress* applications in 24 hours. Borrowers using this program are required to receive pre- and post-loan closing technical assistance and counseling from SBA-designated providers.¹² The purpose of the counseling is to provide borrowers the support they need to facilitate successful loan performance.¹³ The maximum loan amount under this program is \$250,000, and the average loan in 2007 was \$27,000. While *CommunityExpress* loans are only 2 percent of the total 7(a) dollar volume, this pilot program grew more than 30 percent between 2006 and 2007. This program, more than any other 7(a) product, assists minority-owned companies, and in 2007, 70 percent of these loans went to minority borrowers.¹⁴

Patriot Express

While the 7(a) program has always been available to veterans, in 2007 the SBA introduced the Patriot Express product with special features benefiting veterans. Patriot Express loans are similar to the *SBAExpress* in that they are approved rapidly yet have the Standard 7(a) guarantee level. These loans are available to military service personnel leaving active duty, reservists, and members of the National Guard. Spouses of active military members, reservists, members of the National Guard, and widowed spouses of former service members who died during duty are also eligible. In 2007, the average Patriot Express loan was approximately \$100,000.¹⁵

CAP Lines, International Trade, and Export Working Capital

The 7(a) program also has three other subprograms: the CAP Lines, International Trade, and Export Working Capital. The CAP Lines are short-term lines of credit, up to \$2 million, for working capital needs associated with specific contracts. The International Trade product provides a loan guarantee for long-term fixed assets to businesses involved with global trade. The Export Working Capital product helps exporters with working capital needs for shorter term

¹⁰ From the program's inception, the *CommunityExpress* program has concentrated on low- and moderate-income areas, but as of October 1, 2008, program eligibility will be revised to incorporate middle-income areas. Additionally, the maximum interest rate will be lowered to the Standard 7(a) program rate (see Table 1). See Marissa Fajt, "SBA Opening Up Popular Program to More Borrowers," *American Banker*, July 21, 2008.

¹¹ SBA. *SOP 50-10(5): Lender and Development Company Loan Programs*. Washington, D.C., 2008.

¹² Banks can locate SBA-designated *CommunityExpress* technical assistance providers in their area by accessing the SBA's Web site: www.sba.gov/localresources/index.html or by calling their local SBA district office.

¹³ Sharon Evans, "Business Assistance Partnerships Help Minority Entrepreneurs – and Boost Bank Profits," *Community Developments*, OCC, 2003. Technical assistance providers often assist borrowers with financial analysis, such as estimating cash flow, and help them structure their business plans for sustainable, long-term growth. They also can provide post-closing counseling to borrowers.

¹⁴ National Community Reinvestment Coalition, "CommunityExpress Hits Record Numbers, Expands Coverage in New Areas," *Reinvestment Works*, Spring 2008.

¹⁵ SBA data.

durations, such as a single transaction cycle.¹⁶ International-related 7(a) loans are not originated at the same volume level as some other 7(a) subprograms, and in 2007 international loans accounted for only 3 percent of approved 7(a) loans.¹⁷

Table 1. 7(a) Subprogram Overview

Programs	Maximum Loan Amt.	Percent of Guaranty	Use of Proceeds	Maturity	Maximum Interest Rates
Standard 7(a)	\$2 million	75% if over \$150,000 85% if \$150,000 or under	Expansion/renovation; new construction; purchase of land or buildings; purchase of equipment, fixtures, leasehold improvements; working capital; debt refinance; seasonal line of credit; inventory	Depends on loan purpose: working capital is approximately 5 to 7 years; machinery and equipment not to exceed average life expectancy; real estate and construction up to 25 years	Loans up to 7 years: prime +2.25%; Loans over 7 years: prime +2.75%; Rates can be higher by 2% for loans \$25,000 and less and 1% higher for those between \$25,000 and \$50,000
SBA Express	\$350,000	50%	Principally used for revolving line of credit (but can also be used for Standard 7(a) loan purposes)	Maximum 7 years	Loans \$50,000 or less: prime +6.5%; Loans \$50,000 or more: prime +4.5%
Community Express	\$250,000	Same as Standard 7(a)	Same as SBAExpress	Same as SBAExpress	Same as SBAExpress*
Patriot Express	\$500,000	Same as Standard 7(a)	Same as Standard 7(a)	Same as Standard 7(a)	Same as Standard 7(a)
CAPLines	\$2 million	Same as Standard 7(a)	Finances working capital needs associated with specific contracts	Up to 5 years	Same as Standard 7(a)
International Trade	\$2 million	Same as Standard 7(a)	Acquisition of long-term fixed assets	Up to 25 years	Same as Standard 7(a)
Export Working Capital	\$2 million (may be combined with International Trade)	90% up to \$1.5 million maximum	Short-term working capital loans for exporters	Generally 1 year or single transaction cycle	No cap

Source: SBA.

* On October 1, 2008, the maximum interest rate for the CommunityExpress program will be the same as the Standard 7(a) loan.

Existing and New Businesses

The 7(a) Loan Program supplies credit to both existing and new small businesses.¹⁸ Over the last three years, approximately two-thirds of 7(a) loan dollar volume has gone to existing businesses and one-third to new enterprises (see Table 2).

¹⁶ Single transaction cycle refers to the time it takes to complete an international export deal. For export transactions, pre-shipment working capital to finance the production cycle and post-shipment working capital are sometimes necessary. Under the Export Capital program, credit is typically supplied for up to a 12-month period to cover these expenses. The loan balance is paid off after the deal is completed.

¹⁷ SBA data.

¹⁸ According to the SBA, new businesses are those that have been in existence two years or less.

**Table 2. 7(a) Dollar Volume for Existing and New Businesses,
2005-2007 (\$ 000s)**

Year	Existing	% of Total	New	% of Total	Total
2005	10,878	71.0	4,345	29.0	15,223
2006	9,709	67.0	4,815	33.0	14,524
2007	9,194	64.0	5,097	36.0	14,291

Source: SBA.

II. Why Is the SBA 7(a) Loan Program of Interest to Banks?

Market Conditions

Historically, the SBA 7(a) Loan Program has been an important tool for providing loans to customers who do not meet conventional underwriting criteria. And, when business lending risk increases through stages of a credit cycle, the 7(a) program may be a valuable risk mitigant.¹⁹ In previous economic downturns, the 7(a) program has been counter-cyclical in nature, increasing in loan volume when economic growth slowed.²⁰ During the current economic period, the SBA 7(a) loan may be an ideal product for reaching new customers.

New Business Development Opportunities

7(a) borrowers often have limited collateral, need a longer maturity, or lack sufficient equity to qualify under a bank's general underwriting criteria.²¹ Rather than turning someone down for a conventional loan, banks can offer eligible applicants 7(a) loans. Businesses receiving 7(a) loans may become repeat customers. Some banks interviewed reported that enterprises starting with 7(a) loans transitioned to conventional lending services once their businesses became more established and required additional financing to grow. Furthermore, 7(a) borrowers may open additional accounts with their lending institution, establishing full banking relationships, such as checking and payroll accounts.

Profitability

There are several ways that the 7(a) program can help increase bank profitability. By minimizing credit risk, this product allows banks to earn interest on loans they might not have otherwise made. Additionally, the guaranteed, and, to a lesser extent, the unguaranteed, portion of a 7(a) loan can

¹⁹ As of this report's publication date, the U.S. economy was experiencing a slowdown, linked in part to a downturn in the housing market.

²⁰ In the first quarter of fiscal year 2008, 7(a) volume has slowed, not increased. However, it is still too early in the economic downturn and fiscal year to know if the 7(a) program will perform in a counter-cyclical manner. For more on this see Kent Hoover, "The SBA Will Be Less Helpful During This Turndown," *Philadelphia Business Journal*, February 4, 2008, and Jeremy Quittner, "SBA 7(a) Loans Drop 18%," *BusinessWeek*, June, 20, 2008.

²¹ GAO. *Small Business Administration: Additional Measures Needed to Assess 7(a) Loan Program's Performance*. Washington, D.C., 2007.

be sold into the secondary market. This process can generate fees typically ranging from 4 percent to 6 percent of the loan, depending on rate, maturity, and market conditions.²² For instance, if a bank makes a 7(a) loan (20-year maturity at 2 percent over prime) with a principal balance of \$500,000, which is 75 percent guaranteed, and a secondary market investor offers a 6 percent premium, the originating bank can earn approximately \$22,500 for selling the guaranteed portion. When banks sell their 7(a) loans to the secondary market, they are required by the SBA to retain servicing. Typically a 1 percent annual servicing fee on the guaranteed loan portion, which is sold, is retained by the lender. Moreover, the bank earns interest income on the unguaranteed portion of the loan (see Appendix B for a more specific break down of a typical 7(a) loan sale). While several banks we interviewed sell most of the 7(a) loans they originate, secondary market premiums have declined somewhat since July 2007, and, in the current market, banks are holding more loans on their books.

Liquidity Management

Liquidity management policies for national banks direct them to have sufficient assets on their books that can be easily converted to cash if needed.²³ As previously mentioned, there is a secondary market for the guaranteed portion of 7(a) loans. By selling these loan portions, banks can help manage liquidity issues, which can enable them to recycle funds for new loans or use the proceeds for other purposes.²⁴ Banks typically sell the guaranteed portion of their 7(a) loans but have the ability to sell part of the unguaranteed portion as well.²⁵ While demand in the secondary market has declined, it is still active and can be a means for meeting liquidity needs.

Mitigating Risk

The 7(a) program provides a 50 percent to 85 percent federal guarantee on small business loans. If a loan defaults, the bank, after the liquidation of collateral, receives from the SBA the remaining unpaid principal and interest of the guaranteed loan portion on a pro-rata basis. Table 3 illustrates how the 7(a) program decreases a bank’s exposure when lending to small businesses. In this example, a \$400,000 loan with a 75 percent guarantee exposes the bank to a maximum of \$100,000.

Table 3. Hypothetical Small Business Expansion Plan

Total Project Cost	\$500,000
Less Borrower Equity (20%)	-\$100,000
Loan Amount	\$400,000
Less SBA 7(a) Guarantee (75%)	-\$300,000
Bank Exposure/Unguaranteed (25%)	\$100,000

²² Premiums can vary based on market conditions. The banks we interviewed specified that they typically received secondary market premiums ranging from approximately 4 percent to 6 percent.

²³ OCC. *Comptroller’s Handbook: Liquidity*. Washington, D.C., 2001.

²⁴ Banks should underwrite these loans so they are prepared to hold them on their books if secondary market conditions change.

²⁵ The SBA requires that lenders keep 10 percent of the gross loan. With the SBA’s permission, banks can reduce their share to 5 percent. See SBA. *SOP 50-10(5): Lender and Development Company Loan Programs*. Washington, D.C., 2008.

Legal Lending Limits

Some community and midsize banks with smaller legal lending limits may find the 7(a) program valuable to expanding their commercial lending business. The federally guaranteed portion of a SBA 7(a) loan does not count toward a bank's legal lending limit.²⁶ By utilizing the 7(a) program, lenders can make larger loans to some customers that they might not otherwise be able to serve. The amount applied against the bank's legal lending limit is the unguaranteed portion of the loan. If a bank's legal lending limit is \$500,000, the bank may make a \$2 million 7(a) loan if it has a 75 percent guarantee, because the guaranteed portion (\$1,500,000) is not included in the limit.

The Community Reinvestment Act (CRA)

Banks may receive positive CRA consideration for providing credit under the 7(a) program. For example, banks evaluated under the large bank test receive positive CRA consideration for originating and purchasing small loans to businesses, including SBA loans, which are \$1 million or less in amount. In addition, providing technical assistance on financial matters to small businesses (generally those with gross annual revenues of \$1 million or less) is considered a community development service under the CRA. For additional information and guidance on CRA, refer to the regulations and the Interagency Questions and Answers on CRA, both available on the Federal Financial Institutions Examination Council Web site.²⁷

III. How Does the SBA 7(a) Loan Program Work?

The 7(a) program guarantees up to 85 percent of a loan's amount depending on size, terms, and purpose. The maximum gross loan amount under this program is \$2 million. Guarantee fees, paid by participating lenders and borrowers, provide the necessary amount for loan default payouts. Eligible businesses for the 7(a) program must be profit-seeking entities (nonprofits are ineligible) that meet the SBA's size standards: typically less than 500 employees and less than \$5 million in annual sales.²⁸ Businesses must also show good character, credit, management, ability to repay, and an inability to receive credit elsewhere.²⁹

Marketing

Banks locate their 7(a) customers in several ways. Many get referrals from other banks, accountants, attorneys, and business brokers.³⁰ Other lenders find it useful to attend trade association conferences as well as advertise in trade and professional publications to reach potential clients. Banks will also partner with SBA district offices to conduct direct outreach to prospective small business borrowers at planned events.

²⁶ See 12 CFR 32. Additionally, as stated in 12 CFR 34, the guaranteed portion of a 7(a) small business real estate loan does not count against the loan-to-value ratio when determining adequate collateral for a loan.

²⁷ www.ffiec.gov/cra/ (accessed June 20, 2008).

²⁸ The size standard varies somewhat based on the particular business type. See SBA. *SOP 50-10(5): Lender and Development Company Loan Programs*. Washington, D.C., 2008.

²⁹ Inability to receive credit elsewhere is determined if conventional underwriting procedures do not allow the bank or lending institution to offer reasonable credit terms. See SBA. *SOP 50-10(5): Lender and Development Company Loan Programs*. Washington, D.C., 2008.

³⁰ Other studies indicate that lenders also find 7(a) customers with internal bank business development staff and through walk-ins at branches. See Kenneth Temkin, Brett Theodos, Kerstin Gentsch, and Mark Woolley. *An Analysis of the Factors Lenders Use to Ensure Their SBA Borrowers Meet the Credit Elsewhere Requirement*. The Urban Institute, Washington, D.C., 2008.

Lenders that provide small business financing in underserved markets also may explore developing collaborative relationships with government agencies, foundations, universities, and other organizations that provide resources for small business development. Organizations such as SBA-sponsored Small Business Development Centers (SBDCs) and the Service Corps of Retired Executives (SCORE) assist borrowers with business plan development, marketing strategies, and loan packaging services. Banks that partner with nonprofit technical assistance providers may increase their capacity to make safe and sound 7(a) loans.³¹

Bank Structure

The number of lending staff dedicated to 7(a) products depends on a bank's business model and whether government lending is central to its overall strategy. Some community and midsize banks have small SBA or government lending units staffed with two or three loan officers. Other banks integrate their SBA lending within their conventional small-business finance division or have a primary lending officer within the conventional unit who specializes in SBA loans. One midsize bank interviewed had 16 staff dedicated to government lending; however, among smaller lenders, this capacity is rare.

Application Package

If a borrower is unable to qualify for a conventional loan based on conventional underwriting procedures, a bank may decide to submit a guaranty application to the SBA. Lenders we interviewed estimate that completing a 7(a) guaranty application package takes five to seven business days. The majority of the time is spent collecting the necessary documentation from the borrower. A loan officer must ensure that all of the proper documentation material is provided to the SBA's 7(a) Loan Guaranty Processing Centers. Loan guaranty applications include, but are not limited to, the 7(a) eligibility questionnaire; a list of collateral; personal financial statements; business financial statements, such as balance sheets, reconciliation of net worth, and cash flow projections; a history of the business; resumes of principals; and an explanation of how the proceeds will be used.³² The SBA processing centers require detailed information that must be complete for an application to be approved in a timely manner. If any of the required information is absent, it can slow down the approval process.³³

Processing, Servicing, and Guaranty Purchase

Lenders provide 7(a) loan products by working in conjunction with the SBA's processing, servicing, and guaranty purchase centers. For Standard 7(a) loans, lenders submit their guaranty applications to one of two processing centers in California and Kentucky depending on the borrower's location. Applications submitted under any delegated authority are sent to California. After receiving guaranty approval from the SBA, the bank closes the loan. After closing, the lender services the loan and the SBA moves the loan records from the processing centers to one of two commercial loan service centers in California and Arkansas. If a loan defaults, the bank must

³¹ OCC. *Effective Strategies for Community Development Finance*. Washington, D.C., 2000.

³² For a complete list of application materials, see www.sba.gov/idc/groups/public/documents/wi_milwaukee/7a_instructions.pdf (accessed February 26, 2008).

³³ According to the SBA, the most common reasons applications are delayed are that the repayment ability is not properly demonstrated; the personal financial statements are incomplete; available collateral is not pledged; the loan term requested exceeds standard policy; the standard application form (SBA Form 912) is incomplete; the explanation of tax liens is not provided; and the current financials, affiliate information, statement of personal history (SBA Form 912), and performance balance sheet are missing.

request that the SBA honor its loan guaranty, which is known as a guaranty purchase by the SBA and a guaranty payout by bankers.³⁴ This request, depending on loan type, is either handled by the assigned SBA service center directly or is transferred to the National Guaranty Purchase Center in Virginia. In most cases, when a loan defaults, the liquidation of the collateral is completed by the bank and occurs prior to the SBA's payout of the remaining guaranteed portion of the loan balance.

Lender Status

The SBA works primarily, but not exclusively, with a group of 7(a) certified and preferred lenders. The agency also accepts applications from general participants (GPs). The GPs are lenders who originate a small number of loans annually and often have less familiarity with the program. These lenders are required to submit additional loan documentation to support their credit analysis, which includes an in-depth analysis of the borrower's repayment ability. For GPs, the SBA loan guaranty review and approval process typically takes between five and ten business days since the SBA confirms the credit decision of the originating lender with its own analysis. GPs also have to submit paperwork to the SBA for certain servicing and liquidation procedures.

Certified Lender Program (CLP) participants have proven knowledge of the SBA's credit and eligibility requirements, resulting in a less time-intensive SBA review. The advantage of the CLP status is that it expedites the loan guaranty approval process, typically three business days for CLP lenders. It also gives a CLP lender more latitude to service 7(a) loans and secure collateral, if necessary, without prior SBA approval. A representative of the SBA's district offices can nominate a bank for CLP status or a lender may request to be considered for this status. Criteria for CLP designation include: (1) having the ability to process, close, service, and liquidate loans; (2) having staff with prior SBA lending experience; and (3) having a good 7(a) lending track record, evidenced by the bank's prior 7(a) default rate or SBA guaranty purchase rate.³⁵ SBA district directors may approve and renew a lender's CLP status. If for some reason the district director denies the request for CLP status, the lender may appeal to the SBA's Director, Office of Financial Assistance, whose decision is final. The CLP status is typically conferred for up to two years, upon which the lender must undergo a review to be renewed.

Preferred Lender Program (PLP) status gives lenders the ability to apply their own underwriting procedures, owing to their proven understanding of the agency's policies and procedures. Additionally, PLP lenders are not required to submit their credit analysis to the SBA but rather a short checklist as verification that appropriate customer assessments were conducted. PLP applications are typically approved within 24 hours.³⁶ PLP lenders usually have much greater loan volume than the GP and CLP lenders. The guidelines for becoming a PLP lender are similar to obtaining the CLP status. A lender can be nominated by a SBA district employee or may make a request to SBA headquarters to become a PLP lender. PLP designation decisions are made exclusively by the SBA's Director, Office of Financial Assistance, in Washington, D.C. PLP status is then subject to renewal by the SBA every one or two years. There is no requirement that PLPs have a history of CLP participation; however, to be selected for the PLP, a bank must demonstrate that its credit and underwriting staff have substantial SBA lending experience.³⁷

³⁴ A guaranty purchase is when the bank submits a request to the SBA for the payout of the guaranteed portion of the 7(a) loan if the borrower defaults. The SBA's payment to a bank on the guaranteed portion of a loan is known as the guaranty payout.

³⁵ A bank's SBA guaranty purchase rate refers to the rate at which the bank requests that the SBA honor 7(a) guarantees.

³⁶ For a list of preferred lenders, see www.sba.gov/idc/groups/public/documents/sba_homepage/serv_fa_plplist.doc (accessed February 26, 2008).

³⁷ To offer *SBAExpress* and *CommunityExpress* loans, lenders must also be selected by the SBA. The selection process is similar to becoming a CLP and PLP lender. Many CLP and PLP lenders are also SBA approved to offer the *SBAExpress* and *CommunityExpress* products.

While the PLP status enables banks to close 7(a) loans much more efficiently, some PLP lenders, as a business strategy, occasionally submit their loan applications as CLPs. If there is a particular qualification issue that needs to be addressed, it is prudent to have a more thorough SBA review where the SBA makes the final determination. For example, this might include circumstances when a home equity credit line or a gift from a relative is used as the downpayment. Another circumstance might be when combined financing of a 7(a) loan and a non-7(a) loan is proposed. There are special requirements for applications with combined financing, and these requests are more rigorously examined.

IV. What Are the Key Risks and Regulatory Considerations Presented by the SBA 7(a) Loan Program?

Most banks we interviewed indicate that their 7(a) portfolio have a higher default rate than their conventional loans. Based on the SBA's projection models, approximately 7 percent of 7(a) loans originated in 2005, 2006, and 2007 will default at some point, which, after liquidation, will generate a loss rate of 3.5 percent over the life of these loan cohorts.³⁸ The loss rate is used by the SBA to determine the guarantee fee structure, but it is also useful for banks to consider because it approximates their estimated loss rate on the unguaranteed portion of 7(a) loans. To mitigate default and loss risk, the SBA has standard requirements that reduce risk, such as having lenders take first lien on collateral and requiring an in-depth credit analysis that confirms an ability to repay.

Although 7(a) loan recipients present a greater risk of default to banks, the SBA's Standard Operating Procedures (SOPs) require lenders to reasonably ensure that borrowers have sufficient ability to repay when a loan is closed. Lenders must conduct an appropriate credit analysis, including a projected cash flow report. Although there are no SBA guidelines for debt service coverage and loan-to-value ratios, according to a recent Urban Institute study, 7(a) lenders typically require a debt service coverage ratio of 1.2 and a loan-to-value ratio less than 80 percent.³⁹ Lenders do have the option to originate 7(a) loans that provide 100 percent financing, giving banks the flexibility to make loans to borrowers with limited equity, but this is not typically done.

The SBA relies mainly on banks to perform the necessary underwriting procedures for most 7(a) loans. Lenders we interviewed indicate that automated underwriting systems are typically used for SBA loans under \$100,000, while manual underwriting is traditionally used for loans above \$100,000.⁴⁰

The SBA's SOPs help to ensure that 7(a) loans are originated in a safe and sound manner to those small businesses that are least likely to receive reasonable credit in the conventional market. These protocols must be followed to receive the full guaranty payout in the event of default. Without proper due diligence on these matters, a bank runs the risk of the SBA not honoring the guaranty.⁴¹

³⁸ SBA data.

³⁹ Kenneth Temkin, Brett Theodos, Kerstin Gentsch, and Mark Woolley. *An Analysis of the Factors Lenders Use to Ensure Their SBA Borrowers Meet the Credit Elsewhere Requirement*. The Urban Institute, Washington, D.C., 2008.

⁴⁰ Steve Bauer, "Concepts of Commercial Lending Credit Scoring – A Decade Later," *Community Developments On-Line*, OCC, 2003 and Kenneth Temkin, Brett Theodos, Kerstin Gentsch, and Mark Woolley. *An Analysis of the Factors Lenders Use to Ensure Their SBA Borrowers Meet the Credit Elsewhere Requirement*. The Urban Institute, Washington, D.C., 2008.

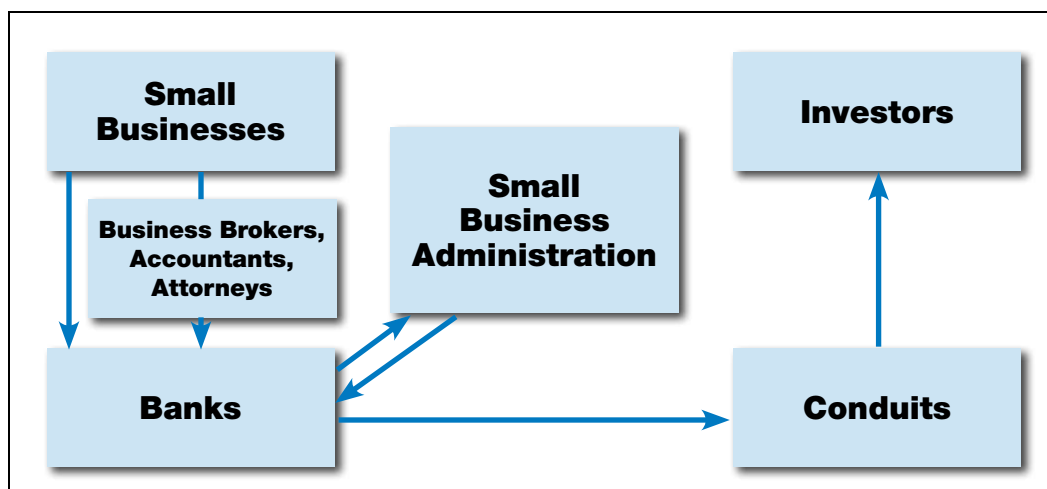
⁴¹ Walter Intlekofer, "When a Default Occurs...Ensuring Prompt Payment of your SBA 7(a) Loan Guaranty," *Community Development Online Version*, OCC, Winter 2003, www.occ.gov/cdd/CD_winter03/images/business.PDF (accessed August 14, 2008).

The SBA recently established on- and off-site lender examination and review programs, which are completed by the agency's Office of Credit Risk Management. The reviews increase the SBA's risk management capacity and help to reduce lending fraud and loan losses. The SBA typically uses the on-site reviews for banks with a total outstanding 7(a) portfolio of \$10 million or more. The on-site reviews are to ensure that large-volume 7(a) lenders are originating and servicing loans according to the program's standards. The off-site reviews identify banks with poorly performing 7(a) portfolios. Once lending institutions are identified as underperforming, the SBA will take appropriate actions, which might include revoking a bank's preferred lender status.

V. Who's in the SBA 7(a) Business Today?

A diverse group of participants and institutions make up the 7(a) industry. They include small businesses, business brokers, banks ranging from large to small, the SBA, conduits, and investors (see Figure 3). While the SBA, small businesses, and commercial lenders are central players, other participants, such as investment banks and institutional investors, are critical to the functioning of, and demand for, the 7(a) product line.

Figure 3. Credit Market Participants for the 7(a) Program



Small Businesses and Brokers

Enterprises receiving 7(a) loans are spread across the country and span the agricultural, manufacturing, service, and construction sectors of the economy. The 7(a) program contributes a much greater proportion of loans to start-ups and women- and minority-owned businesses than the conventional market contributes.⁴² While the SBA permits loans to companies with up to 500 employees, most 7(a) loan recipients have fewer than 25 employees.⁴³ Although small enterprises often form their own relationships with particular 7(a) lenders, some work through business brokers, accountants, or attorneys. Business brokers function much like mortgage brokers and charge a fee for contacting lending institutions on behalf of the borrower and preparing their documentation information. The business brokers, accountants, and attorneys, assist by referring potential 7(a) customers to banks.

⁴² GAO. *Small Business Administration: Additional Measures Needed to Assess 7(a) Loan Program's Performance*. Washington, D.C., 2007. According to this study, between 2001 and 2004 conventional lending contributed 5 percent to start-ups and 9 percent to minority-owned small businesses, while the 7(a) program contributed 25 percent to both categories.

⁴³ Shelli Rossman, B., Brett Theodos, Rachel Brash, Megan Gallagher, Christopher Hayes, and Kenneth Temkin. *Key Findings from the Evaluation of the Small Business Administration's Loan and Investment Programs: Executive Summary*. The Urban Institute: Washington, D.C., 2008.

Bank Participation and the SBA

More than 2,000 lenders worked with the SBA to originate 7(a) loans in 2007. By far, the overwhelming majority of 7(a) lenders originate less than 10 7(a) loans per year (see Table 4). The smallest group of 7(a) lenders originate more than 1,000 7(a) loans per year. In 2007, the average number of 7(a) loans per lending institution was 44, but there was a wide range with a minimum of one and a maximum of 10,878 loans. The average 7(a) dollar volume per lender in 2007 was more than \$6 million.⁴⁴

Table 4. SBA 7(a) Loans in 2007

Number of Loans	Number of Lenders
1 to 9	1,665
10 to 49	460
50 to 99	66
100 to 999	66
1,000+	17

Source: SBA.

Lenders interact with SBA district office staff as well as representatives from the SBA's loan processing, servicing, and guaranty purchase centers. However, for the most part, the SBA relies on the banks to make decisions concerning 7(a) loans. For most banks, critical SBA interactions occur during the approval process and when guaranty purchase requests are necessary.

Conduits and Investors

Conduits and investors are important secondary market participants, who, under certain circumstances, can drive lender volume and preference for using the 7(a) loan product. The conduits are investment houses that buy commercial loans from lenders and package them into securities, usually bonds, and sell them to institutional investors, such as hedge and pension funds. Banks typically contact multiple investment houses and sell their loans to the institution with the highest offer. Banks document secondary market transactions by working through the SBA's designated fiscal transfer agent.⁴⁵ It is also important to note that 7(a) loan originators typically maintain servicing responsibility, permitting the bank to maintain its relationship with the borrower.

VI. How Does the SBA 7(a) Cost Structure/Pricing Work?

The SBA establishes maximum interest rate and maturity requirements and banks must structure their 7(a) products within these limits. The maximum rates are determined by the loan type, maturity, and the gross loan amount. For Standard 7(a) loans with a maturity of seven years or less, the maximum rate is prime +2.25 percent, while loans over seven years are prime +2.75 percent.⁴⁶ Rates can be 2 percent higher for loans \$25,000 or less and 1 percent higher for

⁴⁴ One must be cautious in interpreting the average dollar volume because a small group of large active lenders pulls up the average. The median lender dollar volume originated in 2007 was just over \$1 million.

⁴⁵ The fiscal transfer agent (FTA) serves as a central registry of owners of guaranteed interests and of all SBA guaranteed interest sold or resold in the secondary market. The FTA ensures that principal and interests payments by borrowers are passed onto 7(a) secondary market investors. See Small Business Administration. *Audit of SBA's Oversight of the Fiscal Transfer Agent for the 7(a) Loan Program*. Washington, D.C., 2003.

⁴⁶ Maximum rates for SBAExpress loans are slightly higher (refer to Table 1).

those between \$25,000 and \$50,000.⁴⁷ The maturity is based on loan use. Working capital loan maturities typically range from five to seven years. Machinery and equipment loan maturities cannot exceed the average life expectancy of the equipment, and real estate loans can have up to a 25-year term (see Table 1).

A variety of external factors determine whether banks obtain the SBA's maximum interest rate, and due to price competition, lenders rarely originate loans at the maximum allowable rate. Banks typically set rates at 1 percent and 1 ½ percent above prime for larger real estate loans, and between 2 percent and 2 ¼ percent for shorter-term financing. As with most loans, the risk level is factored into the pricing, and those borrowers perceived as more risky are offered loans at higher rates.

Under the SBA's lending rules, 7(a) loans can be variable or fixed rate. However, all the lenders to whom we spoke use variable rates. The rate typically adjusts every quarter with the prime rate. Lenders may establish ceilings and floors for variable rate loans. The floor must be equal to or greater than the difference between the stated rate and the ceiling. For instance, if the beginning rate is 9 percent and the ceiling is 200 basis points above the beginning rate, the ceiling would be 11 percent and the floor must be 7 percent or less.⁴⁸

A recent study by the Government Accountability Office determined that 7(a) loans are typically priced 1.8 percent higher than comparable conventional loans.⁴⁹ The higher rate is largely owing to the heightened risk associated with 7(a) loans and the fact that these loans are more resource intensive to document, underwrite, close, and service compared with conventional loans.

Packaging and Guaranty Fees

Several fees are associated with 7(a) loans. A packaging fee, ranging from \$1,000 to \$2,500, is typically charged by a bank to the borrower for assembling the loan guaranty application. There is also a one-time upfront guaranty origination fee, which is paid by the bank to the SBA when the loan is approved, but typically assessed to the borrower in the loan financing. The guaranty origination fee is based on the maturity and the gross loan amount, but it is only paid based on the amount guaranteed (see Table 5). If the maturity is one year or less, the fee is 0.25 percent of the guaranteed amount. Loans with a maturity over one year and a gross loan amount of \$150,000 or less have a 2 percent fee. Loans ranging from \$150,001 and \$700,000 have a 3 percent fee and those over \$700,000 have a 3.5 percent fee. Any loan guaranty over \$1 million has a 3.75 percent fee on the guaranteed amount above \$1 million. There is also an annual guaranty fee, which is set each year and is currently 0.545 percent of the remaining balance of the guaranteed portion of the loan. This fee is paid monthly and exclusively by the lender and can not be passed onto the borrower.

⁴⁷ The prime rate is published in *The Wall Street Journal* and is related to the federal funds rate set by the Federal Reserve Board.

⁴⁸ SBA. *SOP 50-10(5): Lender and Development Company Loan Programs*. Washington, D.C., 2008.

⁴⁹ GAO. *Small Business Administration: Additional Measures Needed to Assess 7(a) Loan Program's Performance*. Washington, D.C., 2007.

Table 5. Guaranty Origination Fees

Gross Loan Amount	Maturity	Fee Percent* (on Amount Guaranteed)
Any loan size	1 year or less	0.25
\$150,000 or less	over 1 year	2.0
\$150,001 - \$700,000	over 1 year	3.0
\$700,000 +	over 1 year	3.5

* Any loan guaranty over \$1 million has a 3.75 percent fee on the guaranteed amount above \$1 million.

Oversight Fees

Lenders may also have to pay oversight fees for on-site examinations and reviews as well as for off-site reviews and monitoring. The oversight fees affect high-dollar volume lenders but are minimal for smaller, low-volume banks, which make up the vast majority of participating 7(a) lenders. On-site examinations and reviews are typically conducted for lenders that have an outstanding 7(a) portfolio of more than \$10 million in SBA-guaranteed loans.⁵⁰ The exams and reviews occur on a 24-month cycle and individual lenders are responsible for paying the costs associated with their own exams/reviews. Examination costs vary, but the SBA projects that for a bank with \$1 billion in outstanding loan balances (with 71 percent of that portfolio guaranteed by the SBA), fees for this service will cost approximately \$81,000 per year. On-site reviews, compared to on-site examinations, are less costly and are estimated to be between \$20,000 and \$24,000. To support the off-site reviews and monitoring, all participating 7(a) lenders pay a fee that amounts to approximately \$73 for every \$1 million in guaranteed dollars. The SBA waives the off-site oversight charges for all lenders with fees under \$200.⁵¹

Prepayment Penalties

Prepayment penalties are not permitted for loans that have maturities under 15 years. However, prepayment penalties are required for loans that have terms of 15 years or more if 25 percent or more of the loan is prepaid within a year during the first three years. The prepayment penalties are as follows: 5 percent of the prepayment during the first year, 3 percent during the second year, and 1 percent during the third year. The prepayment penalties are paid by the borrower to the SBA.⁵²

VII. What Barriers Have Limited Bank Participation in the SBA 7(a) Loan Program?

Processing Time

Some lenders are concerned about the amount of time it takes the SBA to process 7(a) approvals. To address the time lag, the SBA has moved toward a more centralized and automated approval structure, which has greatly reduced the processing time. Processing time is estimated by the SBA to take three days for CLP approvals and 24 hours for PLP, *SBAExpress*, and *CommunityExpress*

⁵⁰ Guaranteed dollars include loans held by the lender, sold into the secondary market, and purchased by the SBA but have not been yet been charged off.

⁵¹ For more on oversight fees see *Federal Register*, Vol. 72, No. 66, May 4, 2007.

⁵² SBA. *SOP 50-10(5): Lender and Development Company Loan Programs*. Washington, D.C., 2008.

approvals.⁵³ Most lenders that were interviewed find this new approval structure a much better system. However, a few small lenders reported that the centralized approval system favored larger banks.

There is some evidence that 7(a) lender participation among community banks has decreased since the SBA discontinued the LowDoc program, which had reduced borrower documentation requirements for smaller lenders.⁵⁴ In 2008, in response to the declining participation among rural lenders, who typically originate fewer than 10 loans per year, the SBA initiated a pilot streamlined process for Standard 7(a) loan submissions, known as Small/Rural Lender Advantage. This program reduces the borrower documentation requirements for community banks operating in certain rural states.⁵⁵ With its more efficient approval system for CLP and PLP lenders, in addition to the Small/Rural Lender Advantage and the expansion of *CommunityExpress*, the SBA is attempting to reduce the processing time for its participating banks.⁵⁶

Timing of Guaranty Payouts

For bankers, one of the primary deterrents to offering SBA 7(a) products has been the time it takes to receive the guaranty payouts from the SBA when loans default. The SBA is aware of some lenders' concern regarding the speed of the guaranty payouts. The SBA typically honors the guaranty within 45 days, but is attempting to accelerate the process to two to three weeks.⁵⁷ Guaranty payouts can take longer if required loan documentation materials are not submitted to the SBA.

Fees and Maximum Loan Limits

Some lenders indicated that the guaranty and oversight fees are too high, making the product less competitive. Certain banks believe these fees will ultimately inhibit the use of the 7(a) product line. The guaranty fee structure was raised to ensure that the program was self-sustaining, and the oversight fees were intended to help the SBA identify underperforming lenders. While some loan officers believe the fee structure is too high, others note that it prevents the program from relying on congressional appropriations, which brings greater stability to the program.⁵⁸ Another issue raised by some 7(a) lenders is the maximum loan amounts. Some bankers believe that the \$2 million gross loan amount should be increased to more than \$3 million to attract more borrowers to the SBA 7(a) program.

⁵³ SBA. *SOP 50-10(5): Lender and Development Company Loan Programs*. Washington, D.C., 2008.

⁵⁴ The LowDoc program was discontinued six years ago. Michele Heller, "SBA Chief Working to Draw Lenders Back into the Fold," *American Banker*, March 11, 2008.

⁵⁵ Small/Rural Lender Advantage is available in most states and will be available throughout the country by the end of FY 2008.

⁵⁶ Michele Heller, "SBA Chief Working to Draw Lenders Back into the Fold," *American Banker*, March 11, 2008.

⁵⁷ Alan Kline, "SBA Poised to Speed Up Guarantees," *American Banker*, October 25, 2007.

⁵⁸ In January 2004, the 7(a) program had to halt its guaranty allocation. To prevent future shutdowns, the SBA raised the guaranty fees to meet expected payout costs, making the program less reliant on congressional appropriations but more costly for lenders.

VIII. Conclusion

The strength of the 7(a) program for many banks is that it can be used for multiple purposes and is extremely flexible. Some banks sell the majority of these loans on the secondary market; others keep them on their books for balance sheet growth. Some banks combine these activities and use 7(a) loans to add to balance sheet growth and sell them when liquidity needs arise. The SBA 7(a) program, if used effectively, can help commercial lenders meet a great range of customer needs. The program not only helps to supply credit to America's small businesses, but simultaneously assists banks with risk mitigation, liquidity management, and regulatory compliance.

Appendix A

Additional Resources

Coleman Publishing
www.colemanpublishing.com

National Association of Government Guaranteed Lenders
www.naggl.org

National Small Business Association
www.nsba.biz

OCC Community Development Newsletter on Small Business Banking
www.occ.treas.gov/cdd/CD_winter03/cd_header.html

The Urban Institute's 7(a) Research
www.urban.org/projects/sba/

SBA, 7(a) Program
www.sba.gov/services/financialassistance/7alenderprograms/index.html

SBA, 7(a) Regulations and SOPs
www.sba.gov/aboutsba/sbaprograms/elending/reg/index.html

Appendix B

Table 6. Illustrative 7(a) Loan Sale Analysis

Loan Amount	\$500,000
Maturity	20 years
Prime Rate ^a	5.0%
Guaranteed Percent (\$375,000)	75%
Unguaranteed Percent (\$125,000)	25%
Gross Rate (Variable Rate, Adjusts Quarterly)	7% (Prime +2.0%)
Servicing Fee (Retained by Lender)	1%
Net Rate (To Investor)	6%
Sale Price ^b	106.75
Premium (%)	6.75%
Guaranteed Portion (Amount to be Sold)	
Current Loan Balance x Guaranteed %	\$375,000
Unguaranteed Portion (Invested Funds)	
Current Loan Balance x Unguaranteed %	\$125,000
Premium (\$) Earned on Sale	\$ 22,500
Servicing Fee on Guaranteed Portion Guaranteed Portion x Servicing Fee (1%)	\$ 3,750
Interest Income on Unguaranteed Portion Unguaranteed Portion x Gross Rate (7%)	\$ 8,750
Year 1 Income Premium + Servicing + Interest ^c	\$ 35,000
Less Guaranty Fee Origination Guaranty Fee ^d (3% of Guaranteed Loan Amount) ^e	-\$ 11,250
Total Year 1 Income	\$ 23,750

^a Prime rate as of July 30, 2008, from *The Wall Street Journal*.

^b Secondary market offer as of July 29, 2008.

^c Banks earn the servicing fee and interest on the unguaranteed portion over the life of the loan.

^d There are additional oversight fees.

^e Origination guaranty fees are based on loan terms (see Table 5).

Derek Hyra was the primary author of this report. Also contributing were William Reeves, Barry Wides, and Julie L. Williams. *Community Development Insights* reports differ from OCC advisory letters, bulletins, and regulations in that they do not reflect agency policy and should not be considered as definitive regulatory or supervisory guidance. Some of the information used in the preparation of this paper was obtained from publicly available sources that are considered reliable. However, the use of this information does not constitute an endorsement of its accuracy by the OCC.