PITFALLS AND WINDFALLS of SBA 7(a) Lending

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BY LUNELLE SIEGEL

When I started in banking in the early 1980s, U.S. Small Business Administration (SBA) lending was considered "last-chance finance." Routinely, potential borrowers would ask me for a "turn-down letter" so they could obtain a direct SBA loan.

Those days are gone. It's not your father's SBA. Today, SBA 7(a) lending depends on financial institutions to provide the loans in exchange for a guaranty (normally to 75%) backed by the full faith and credit of the U.S. government.

7(a) lending is attractive to CEOs, boards, and executive management who seek to bolster loan growth and returns. Government-guaranteed lending is a top tactic in many banks' strategic plans. Banks that will be successful in SBA lending in the medium to long run will implement and maintain the necessary infrastructure to identify, process, book, and monitor eligible SBA loans in compliance with SBA guidance.

This article provides information about the risks and mitigants, which can serve as a foundation for a bank's risk assessment of its current or potential SBA lending process.

Windfalls

Many banks think of SBA as a lending strategy. In today's frothy mergers and acquisitions market, income banks realize from SBA lending can boost their appeal to buyers and, in the process, their sale price. Institutions have recognized that an effective strategy to ramp up their return on equity is to originate SBA 7(a) loans, the guaranteed portion of which can be sold to investors at a premium. This premium can bolster a bank's earnings faster than traditional loan originations and drive up yields.

Meanwhile, 7(a) lending revs up fee income while growing assets. Asset growth can be managed by retaining only the unguaranteed portion (normally 25%) of the loan originations or by holding the guaranteed portion for less current income but faster loan growth.

Loan yields are bolstered by premiums paid and income serviced on the guaranteed portion. Premiums vary but they have been high, causing this yield-enhancing strategy to be favorable to banks that entered the Great Recession with capital to invest.

Below is an example of the terms of a typical 7(a) loan:

Loan amount	$1,000,000
Guaranteed portion	$750,000
Net gain on sale of the guaranteed portion	$101,250
Bank-retained portion	$250,000
Ongoing income	1% servicing on guarantee ($7,500 year one)
Loan yield	9%
Sale gain	49.5% (this gain will be amortized over the loan's life)
Assumptions:	
Loan term	25 years
Collateral	Commercial real estate
Rate	P + 2.75% (6%)
Premium	13.5%

Despite the profits, there are risks to originating SBA 7(a) lending.

Pitfalls

CEOs and credit administrators tend to fall into one of three categories when it comes to SBA lending:

1. They believe it has great potential and want to get started.
2. They have "been there, done that" and wouldn't do it again.
3. They are aware that it is a specialized lending area requiring specialized knowledge to mitigate the risks.

If your CEO is in the second category, it is likely that nothing will change. He or she may have learned the hard way that there is more to the guaranty than the title at the top of the page. Unless they have been through a liquidation in the past, most lenders don't realize that the SBA covers a percentage of the remaining balance *after* the lender has liquidated collateral and called on the guarantors. Only then will the SBA write a check. An analogy would be your auto insurance company paying its percentage of the bill to the body shop after the work has been completed.

As an industry advocate, I am more concerned about the first type of CEO, who doesn't realize what he or she is getting into. I recently conducted an SBA loan audit for a small bank that was growing by originating SBA 7(a) loans. I reviewed a 90% portfolio sample. Of the loans reviewed, none of them would withstand a guaranty claim. The reasons varied, and some are detailed below.

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The good news is that this particular bank recognized the problem before it had accumulated a large portfolio or before an audit by the SBA. It therefore had the opportunity to remediate the portfolio and protect its guaranties and lending license.

In a bank's enterprise risk management review process and/or risk assessment of SBA lending, there are several types of risk that must be identified and mitigated.

Operational risk: Operational risk arises when the bank fails to conform to the SBA guaranty requirements, putting the SBA guaranty in jeopardy. This can arise from internal staff or trusted vendors (including closing attorneys) not following the SBA's standard operating procedure (SOP[1]). There will be more on the importance of SOP later in the article.

Reputation risk: Reputation risks can arise from slow decision-making and/or low approval percentages.

Earnings risk: Earnings risk is created from the potential loss of earnings if the bank loses its ability to participate in the program. It also arises through the following scenario: Since the highest premiums are paid on variable-rate loans, banks' practice of originating loans to sell them for premiums may create a concentration in variable-rate loans. In an increasing-interest-rate environment, such a concentration could result in a higher default rate, putting future earnings at risk.

Credit risk: Credit risk arises when a bank relaxes its credit policy, believing that it will be protected by the SBA guaranty.

While all of these risks are important, shortcomings in operational risk management have arguably been the most damaging to banks participating in the guaranty program.

When a bank seeks to recover on a defaulted loan, it can be faced with denials or reductions in guaranty (repairs). Reasons for denials or repairs vary widely, but they fall into these categories: eligibility, underwriting, closing, servicing, and liquidation.

For denials (complete rejection of a guaranty request), the SBA reports that the main reasons are related to the following examples:

Closing: The lender disbursed loan proceeds not eligible for guaranty or failed to verify a required equity injection.

Underwriting: The lender relied on income not supported by IRS verification.

Eligibility: The borrowers were not eligible (franchises, etc.).

The SBA reports that the main reasons for a repair are related to these examples:

Eligibility: Use of proceeds was not eligible for guaranty.

Underwriting: There was a failure to fully collateralize a loan when additional collateral was available.

Closing: There was a failure to obtain a required lien position or to properly perfect a security interest.

Servicing: Liens were not renewed, collateral insurance was allowed to lapse on destroyed collateral, key-person insurance lapsed, or a principal died.

Liquidation: Failure to conduct a site visit resulted in missed recoveries and misapplication of recoveries.

Depending on the circumstances, lender lapses may result in a denial instead of a repair.

In the aforementioned audit, the bank had an "expert" SBA closing attorney and relied too heavily on the attorney to ensure that loans were closed in accordance with the SBA loan authorization guidelines. Some involved ineligible use of proceeds or an unverified equity injection. One case involved the refinance of existing debt. Under SBA requirements, the bank was responsible for documenting the eligibility of the original debt but failed to do so.

This particular bank engaged in commercial lending, making non-real-estate-secured loans or loans with multiple types of collateral. Two loans were primarily supporting inventory, but the bank did not require hazard insurance for inventory at closing. Imagine the bank's surprise when its request that the SBA honor a guaranty is denied after a fire destroys the uninsured inventory collateral and the loan defaults.

Mitigating SBA Lending Risk

How does a bank mitigate its operational risk and ensure its guaranty is protected? Can a category "two" CEO make SBA 7(a) loans and still sleep at night? Yes, but... SBA 7(a) lending, like construction lending, is specialized and requires specialized credit administration. One bright spot is a new SBA initiative, "SBA One," which promises to reduce eligibility risk through online eligibility determinations.

Training. On my first day on the job in the SBA lending area, I was told, "Read the SOP." I did. The second day I was told, "Read the SOP again." I did. The third time was the charm. The terminology made sense, and I made the connections to my bank credit and lending training.

Some banks engage consultants—often former SBA officials—to train their staff in the process. They frequently put consultants on retainer to call or visit if questions arise. This approach has its advantages, but, like outsourcing, the bank must have options for continuation of service if the vendor is no longer available. The National Association of Government Guaranteed Lenders (NAGGL) and certain state lender associations offer specialized training for origination, operations, and servicing staff who have a role in mitigating SBA lending risk. But regardless of your training source, the SOP is the authority source. Get it and make your staff read it.

Policies and procedures. Best practices provide for specialized policies and procedures for SBA 7(a) lending. The critical policy message is that SBA guidance takes precedence over internal bank policy and procedure. For example, the SBA expects the bank's credit files to be maintained according to the SBA's SOP. Further, workout officers must be aware of restrictions or limitations on their power to service a loan, and operations officers must know about specialized reporting requirements. These must be documented and available to staff, and all staff need to know the "special rules" for SBA government-guaranteed loans. Policies should also define concentrations in favorite SBA lending industries (hotels, restaurants, etc.). Remember, the bank may choose to be more restrictive than SBA guidance, but it cannot be more liberal.

Vendor management/outsourcing. Third-party vendors called lender service providers (LSPs) offer "cradle to grave" service for SBA lenders (including eligibility, closing, servicing, and liquidation). I know several good ones. Other service providers offer to help with certain pieces of the process, such as underwriting. Another benefit to using a "packaging" vendor can be increased premiums garnered through competitive bidding and an expanded bidder network.

Getting an SBA loan "approved" is just the first part of the process. A lender must follow through. If expertise is outsourced, it must be available when needed. Banks need to examine a vendor's ability to provide the promised service, as well as options for continuation of service if the vendor exits the business. Processes between the bank and its vendors should be defined and contracts utilized so that the bank is not relying on vendors, including closing attorneys, to ensure compliance with SBA requirements.

Given the rush to outsource, supervisory authorities are cautioning bankers to establish vendor management policies that scrutinize the risks of reliance on vendors, as well as additional risks of the outsourcing process. For example, how is the vendor handling secure customer files? What is its disaster-recovery policy? What if it makes an error? Does it have errors and omissions insurance? Adding to the FDIC's guidance, both the Federal Reserve[2] and the OCC[3] have issued guidance on third-party relationships in the past year that is helpful in evaluating the outsource option.

Audits. The one way to make sure everything you're doing is working is to check periodically. Banks with specialty products that require regulatory compliance routinely include audits. Internal audit scope should be expanded to ensure compliance with SBA lending requirements from origination through reporting and liquidation. If the bank doesn't have sufficient internal resources to conduct a full review, it can engage a third-party auditor that specializes in SBA lending.

SBA lending can be conducted prudently and profitably, but only if the risks are identified and mitigated.

Conclusion

In the clutch, many SBA lenders have found themselves without the protection they counted on. SBA lending can be conducted prudently and profitably, but only if the risks are identified and mitigated. Sound risk management practices can support this specialized lending technique for the benefit of the shareholders, employees, and the community. ❖

Lunelle Siegel is a veteran commercial lender and executive director at RMPI Consulting LLC, based in Boston and Tampa. She assists financial institutions with regulatory and credit concerns, including SBA loan audits, capital planning, ERM, process improvement, and policy and plan revisions. She can be reached at lsiegel@rmpiconsulting.com.

Notes

1. U.S. Small Business Administration Standard Operating Procedure (SOP) 50-10 5(F), January 1, 2014 (available at http://www.sba.gov/sites/default/files/sops/SOP%2050%2010%205(F)%20March%2024%202014%20FINAL%20CLEAN.pdf).
2. The Federal Reserve System Guidance on Managing Outsourcing Risk, December 5, 2013 (available at http://federalreserve.gov/bankinforeg/srletters/sr1319a1.pdf#!).
3. OCC Bulletin 2013-29, Subject: Third-Party Relationships (available at http://www.occ.gov/news-issuances/bulletins/2013/bulletin-2013-29.html).