The Small Business Administration (SBA) has made money available for banks of all sizes to lend to small business for decades. The SBA was created by Congress in 1953, and is administered by the Treasury Department. By the end of 2005 it had guaranteed more than 100,000 loans worth $20 billion, and for thousands of small and start-up entrepreneurs it has been the very reason their businesses exist.

Here’s what you, the community banker, may not be aware of: The SBA’s primary loan product, the 7(a) program, includes an active, liquid and very profitable secondary market that results in a number of benefits to the lender. This month’s column will describe the process of making SBA loans and selling the guaranteed portions. The strategy has proven to be successful in retaining loan customers and generating considerable fee income for hundreds of ICBA members.

Identifying Prospects

Many bankers fail to adequately identify lending situations which are suitable applications of SBA loan programs. Awareness of these situations will differentiate active SBA lenders from other competitors in the market, and allow these lenders to “think outside the box” when reviewing credit requests. Financing business acquisitions, start-up businesses and specialty businesses are but a few examples.

Business acquisitions typically include some amount of goodwill, which is very difficult to finance. It is generally supported by the going concern value of the business, and is usually separated from hard assets. An independent valuation can be used to support this goodwill portion of an acquisition, and can be reflected on a pro forma balance sheet used in an SBA application.

Start-up business loan requests are often outside of a bank’s conventional underwriting requirements. This risk factor can be mitigated via an SBA guarantee. Specialty businesses such as restaurants, hotels or motels, and convenience stores present banks with a unique set of underwriting challenges. These types of credits, with specialized or unique collateral, make excellent candidates for SBA loan programs.

Another excellent application of SBA loan guaranty programs is “terming out” of existing poorly structured debt or lines of credit. By properly structuring short-term credit facilities, a lender can enhance cash flows for existing, growing borrowers.
The SBA 7(a) loan programs do allow for debt refinancing. Revolving lines of credit too often become “evergreen,” leaving the borrower struggling for cash flow.

A creative banker using SBA loan programs can promote discipline to the borrower by requiring principal reduction of these evergreen lines of credit. The SBA Express loan program (which is for loans up to $350,000) may also be used for companion revolving lines, and carries a 50 percent guarantee.

Loan officers and business development personnel should be trained to identify opportunities to apply SBA loan programs to credit requests. The Small Business Administration has a long history of providing credit enhancements to small borrowers, who emerge and grow and become candidates for conventional lending.

Secondary Market

Once a loan is closed, the guaranteed portion can be quickly and easily sold. In fact, if the lender is interested in selling, it should do so immediately, and for three reasons:

1. There is more to sell on day one than ever again;
2. The longer the time to maturity, the more a loan is worth to a buyer;
3. Loans typically don’t prepay in the first year or so; by waiting, the bank faces the growing likelihood of a valuable asset being converted to cash, at just 100 cents on the dollar.

We use the term “just,” because many SBA loans are worth seven, eight or even 10 points of premium. A Prime + 2 percent loan with a 10-year term is worth around 108.00, which translates into $20,000 of fee income for a loan with a guaranteed portion of $250,000.

Further, this sale is invisible to the borrower. SBA mandates that the seller retain servicing, with very few exceptions. Equally important, the agency also mandates that the seller retain a full 1 percent of the guaranteed loan amount as servicing income, so there is an ongoing income stream that resides with the lender. And the full principal and interest stream from the unguaranteed portion is retained as well, so the yield on the actual dollars committed is quite attractive. Often it is in the double-digits.

Finally, the proceeds from the sale, which typically arrive around four weeks after bid date, can be used to make more loans, pay off borrowings or manage asset/liability positions. In other words, it’s a great technique for leveraging your balance sheet.

Overcoming Objections

When presented with the concept of making use of an SBA loan program, borrowers may raise objections. Typical questions include: “How much does it cost?” and “How long does it take?” Bankers with experienced personnel or those who make use of Lender Service Providers can deliver credit facilities in a timely manner. Banks will often engage these Service Providers to serve as an out of house SBA loan department, thus optimizing personnel costs.

It is true that the SBA assesses user guarantee fees. These fees, along with other bank and related fees are capitalized into the loan request. By structuring credit requests with extended maturities allowed by the SBA, borrowers will typically enjoy excellent improvement in cash flow and debt service coverage.

While the use of Small Business Administration loan programs is an excellent resource for bankers, caution must be exercised. It is critical to understand that the use of a 50 percent to 85 percent guarantee from the SBA does not allow for a poor credit decision. Loan guarantee programs should provide a credit enhancement, not an excuse to make a substandard loan decision.

In summary, Small Business Administration loan programs provide lenders with a tremendous resource to serve borrowers, and thereby compete effectively in the crowded lending marketplace.

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SBA Investments

Through ICBA Securities

ICBA Securities is very active in purchasing and selling 7(a) guaranteed loans. Through its clearing broker Vining Sparks, it is one of the largest poolers of the product in the country. For more information on the secondary market of 7(a) guaranteed loans, please contact your sales rep or reach Jim Reber, ICBA Securities president, at (800) 422-6442 or jreber@icbasecurities.com.