

SBA Lending For Community Banks

A Primer for SBA Lending to Small Business

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Overview

Small businesses are vital to the strength of our economy. They represent 99% of all employer firms and employ half of the private sector workforce. Community banks play a major role in providing capital to small companies. Community banks generally fall into three broad categories in their approach to SBA lending. The first group has contemplated offering the SBA loans but is unsure about proceeding. The second group is semi-committed to making SBA loans at some level and processes a handful. The third group has a strong commitment to utilizing the program. There are a number of solid business reasons for community banks to offer SBA guaranteed loan programs to small business customers – including; **asset soundness**, **bank profitability** and **growth potential**. In today's economy lending is risky, with or without a government guaranty, and the SBA loan process can be onerous. However, there are ways to offer an SBA loan program without a major commitment of time or resources.

SBA Guaranteed Lending Basics:

The SBA 7a guaranty program has been around for more than 50 years and can be used for any business purpose, provided the small business meets certain eligibility requirements. Proceeds may be used for permanent working capital, business start-ups or acquisitions, expansion, equipment purchases, real estate purchases and refinance of existing debts. The SBA program provides an alternative for small businesses to access capital when funding is not available through conventional lending methods. With the 7(a) program, lenders fund 100% of the loan, and the SBA guarantees 75%. By providing a 75% guaranty, the SBA allows banks to lend when there is a collateral shortfall, when longer maturities are needed to improve cash flow, and when the business is undercapitalized. A guaranty won't make a bad loan good, and the primary source of repayment should always be business cash flow.

Business Soundness, Profitability, Growth

A community banker's job is to ensure soundness (protect the bank's assets), achieve profitability (provide a return to shareholders) and grow (meet customer needs). The SBA 7a guaranty loan program offers protection for community banks that want to meet the needs of their local small business clients – while preserving asset quality and providing a good return.

Why community banks should consider offering SBA Guaranteed Loans.

1. **Reduce Risk:** A typical risk reduction strategy is to tighten lending standards, thereby reducing credit availability. While this strategy reduces risk it is particularly harmful to small businesses relying heavily on access to debt for sustainability and growth. The SBA loan programs allow banks to have their cake and eat it too. They can meet their small business customers needs, continue to grow their loan portfolio and reduce risk while generating interest and fee income.
2. **Expand Business Banking Market:** Small business owners consistently express a preference for borrowing from community banks because; (a) they're treated as important customers, and (b) they don't get lost in the system. However, community bankers aren't always able to help their community's small businesses, even though they are the preferred lender. Undercapitalization, longer term requests, and collateral shortfalls are the typical obstacles causing community banks to turn small business customers away, and forcing the owners to go to the competition - often never to return.

In addition to the lost loan opportunity, all of the cross sales opportunities that the business customer represents - business deposits, employee deposits, car loans, HELOCs, and future loans – are forfeited as well. Consider that a 75% SBA loan guaranty mitigates the common small business loan risks and enables community banks to approve loans that fall outside conventional loan policies. The SBA loan guaranty program mitigates risk and facilitates the small business loan while paving the way for future customer opportunities. Ignoring SBA guaranty programs is like handing customers over to the competition along with all the current and future revenue opportunities the customer represents.

3. **Generate Profit with Less Risk:** Let's take a look at a typical SBA 7(a) loan scenario:

Loan Amount: \$500,000
Cost of Funds: 2.0%

Interest Rate: Prime + 2.25%
Gross Income: > \$100,000

Term: 7-year maturity

The same conventional loan will yield the same returns, however with a 75% SBA guaranty the bank's risk and exposure is significantly reduced. And, lenders have the option of selling the guaranteed portion of the loan on the secondary market thereby increasing their yield (and shareholder ROE). Historically, the premium on the guaranteed portion of an SBA loan has been as much as 10%. The current secondary market premiums mirror historical measures, generating lucrative profits while reducing capital exposure. Initial returns are better when selling the loan, and if fee income generation is part of the bank's business model, secondary market sales provide significant and quick returns.

Most companies tend to stick with the lender that provides their financing for deposits and other ancillary services. By not being that lender, fee income opportunities can be lost forever.

4. **Create Liquidity:** While many community banks are well capitalized today, selling the guaranteed portion of an SBA loan on a case by case basis allows community banks to meet the credit requests of key customers or prospects, and retain their business. The focus of secondary market sales today is more about increased yield on credit requests than on liquidity creation.
5. **Reduce Capital Requirements:** Under traditional commercial lending methods a bank funds 100% of its loans and is required to include the entire loan amount in its risk-based asset calculations. With an SBA loan the bank funds 100% of the loan but it only includes the unguaranteed portion (25%) in its risk-based asset calculations, dramatically improving the capital ratios of the bank. In general, if a bank were to use the 75% SBA guaranty on its entire C&I loan production, their Tier 1 Risk Based Asset Ratio would be improved by an average of 15% when risk-weighted assets are adjusted for the guaranteed portion.
6. **Increase Lending Limits:** With SBA lending only the un-guaranteed portion of the loan counts toward the bank's legal lending limit. If a bank makes a \$1.0 million SBA loan with a 75% (or \$750,000) guaranty. The un-guaranteed portion (\$250,000) is all that would count toward the legal lending limit. If a bank has a legal limit of \$1.0 million, it could lend within the maximum allowed under the program, up to \$4.0 million, (the SBA maximum is \$5.0 million), and still be in compliance. This is another way that the SBA guaranty program allows community banks to expand market share, improve profit margins, reducing portfolio risk, and compete with the larger banks.
7. **Mitigate Turbulent Times:** The current economic climate is one of the most challenging in banking history. Today, it's easier to say "no" when business customers submit loan requests than it is to say "yes." But having the ability to say "yes" to the right customer in tough times will cement a relationship that can last for years. A 75% SBA guaranty might just be the security blanket needed to comfortably say "yes" to a small business. That's why smart community bankers are maximizing their use of the SBA program in the current business environment.

In light of these clear and compelling benefits, why don't more community banks take advantage of the SBA 7a loan guaranty program?

Challenges

SBA lending can be challenging for banks that don't have internal SBA expertise. Banks that dabble in this program without experts often have a negative experience due to their own lack of knowledge, understanding and experience. Because they don't understand the policies and procedures associated with SBA lending, they perceive the process as cumbersome, time consuming and fraught with details and requirements that create entirely too much paperwork.

Clearly SBA lending is more exacting than conventional lending. Borrowers must meet eligibility guidelines (businesses cannot exceed revenue or employee size standards depending on their NAICS category). The credit write-up must address specific issues such as the source of an equity injection in a business acquisition. And the SBA's own version of a promissory note is required at closing. After closing, SBA loans have specific servicing and reporting requirements that must be filed regularly. A SBA 7a's guaranty is not unconditional. It is conditioned upon the lender following all SBA policies and procedures; and it is the lender's responsibility to understand those policies and procedures - and to comply. The risk of not getting the details right is losing the guaranty if the loan defaults.

Because of these challenges, many community banks stay away from the program, and that is unfortunate. When done correctly, the program is a terrific tool to expand market share, generate exceptional revenue streams, enhance the quality of commercial loan portfolios, and create customer loyalty.

The Outsource Solution

Community banks have historically outsourced a variety of services, and it makes good business sense to consider outsourcing the SBA loan function. For most community banks, it's the recommended approach. It takes a minimum of three people to properly staff a functioning SBA department: an experienced SBA loan business development officer, an underwriter experienced in SBA underwriting policy, procedure and regulations, and a closer/servicer familiar with SBA loan documentation and reporting regulations. A conservative estimate of salaries alone is \$285k annually. With other costs, (bonus, payroll taxes, benefits, turnover costs, etc.) and overhead factored in, start-up expenses for an SBA loan department are considerably more than most community banks customarily want to invest in a department or product line with unproven demand.

Outsourcing SBA loan origination, documentation and processing is a favored alternative for the community banks who want to offer SBA guaranty loans to their small business customers, but do not want to staff up to do so. Community banks that partner with SBA experts cite the following reasons for doing so:

1. **Convert fixed costs to variable:** The market is full of bankers looking for jobs. However, lenders with SBA experience are limited and working (and making a very lucrative living) for the large bank and non-bank SBA lenders. The model of fixed overhead and variable income doesn't work well in the current economy. Rather than staff up for uncertain demand, savvy banks choose to hire experts and tie a variable revenue stream to variable costs. Resulting profit margins are more consistent and predictable.
2. **Eliminate the learning curve:** SBA lending is complex and bankers typically either specialize or avoid this type of lending. It takes years to fully understand the nuances of the SBA program. Rather than hire internal staff with the hope they are up to speed, community bankers are looking to utilize outside expertise. This approach ensures top talent that is up to date on all current SBA policies and regulations. Eliminating the learning curve also means that the bank can react quickly to market opportunities - good loans disappear quickly, reacting slowly results in the deal walking across the street.
3. **Ensure compliance:** Bankers know that being out of compliance is costly. Compliance is a critical component in SBA lending. Obtaining correct eligibility assessments; underwriting according to SBA policies; and properly closing, funding and servicing SBA loans the "SBA Way" are absolute necessities. The SBA's guaranty is conditional, and lenders must be in compliance with policies and regulations from start to finish. Rather than worry about compliance issues, community banks that outsource to SBA loan origination and loan service provider experts report greater success and peace of mind regarding compliance issues.
4. **Reduce paperwork and hassle:** Most community bankers have heard horror stories about the onerous paperwork involved and how long it takes to process an SBA loan. The following illustrates a common frustration. A lender worked on a loan for three months only to have it declined by SBA for a relatively simple eligibility issue, which an experienced SBA lender would have identified immediately. Often, even sophisticated commercial lenders don't understand what the SBA wants and needs, and the SBA doesn't understand what the banker doesn't know. SBA experts who work with community banks will tell you that most bad experiences are a result of in-house lenders and processors "not knowing what they don't know about the SBA process." Outsourcing cuts through the confusion and red tape. And, when it comes to complicated issues, top SBA experts have built a solid relationship with SBA staff members, and know exactly who to call for answers and fast results.

What to Look For in Outsourced SBA Loan Originators and Service Providers

In SBA lending it is especially critical to get competent experts working with and for the community bank because even one small mistake can be costly, and the SBA holds the bank accountable whether the loan is processed internally or externally. The qualities to look for in selecting an SBA provider include:

1. **Flexibility:** Will the provider adapt its services to fit the bank's business model or require the bank to fit into theirs?
2. **Breadth of Services:** Does the provider offer the full range of services found in a typical SBA Department? From eligibility screening to customer interface, document collection, loan structure, loan summary analysis, through underwriting, closing, funding and servicing, it's important for a community bank's SBA partner to offer a full complement of services. Does the provider offer training, consulting and ongoing support for special

situations? And if the bank requires only a few services to augment existing staff, does the provider allow the bank to pick and choose only what it needs?

3. **Competence and Experience:** How experienced is the staff? Does staff have experience outside the world of SBA? “Real world” lending experience is critical for an SBA provider to optimally function as the liaison between the bank and the SBA.
4. **Response Time:** Banking is a people business. It’s critical to get back to loan customers in a timely manner. Does the service provider have enough staff to be responsive? And, do they have the systems in place to support their services? Good loans go quickly.

These are some of the key characteristics to look for when selecting the best outsourced SBA service provider to assist community banks in taking full advantage of the benefits of SBA loan guarantees without taxing the bank’s resources.

Summary

SBA guaranteed lending is a valuable addition to any community bank’s commercial lending product line. From a business perspective, SBA lending can expand market share, reduce portfolio risk, diversify the bank’s revenue stream and provide an excellent profit stream. However, SBA lending is highly technical and specific; therefore expertise is a critical component for success. Because few community banks make the volume of loans necessary to justify creating their own internal SBA department, contracting outside expertise is recommended. By outsourcing SBA loan origination and processing, community banks and their small business customers reap the benefits of the SBA programs, without having to invest the time, money, energy, overhead and staff required to process these loans.

BizLoanFunding.com

BizLoanFunding.com is an outsourced SBA loan originator acting on behalf of community banks as their SBA Specialist to evaluate, structure, and prepare business loan requests for bank and SBA underwriting and approval. BizLoanFunding.com has partnered with nationally recognized SBA loan service providers to act as the community bank’s ‘backroom’. Together they function as the bank’s own SBA lending department. Our experience and expertise ensures a pleasant SBA 7(a) experience for the bank and its small business customers.

About the Authors

Joe Wojtowicz is the founder of BizLoanFunding.com, a division of 3W Enterprises, Inc. Along with key principal, Dave Nighswander they have a combined +60 years finance, consulting, sales experience. BizLoanFunding is a SBA loan consulting, packaging and placement firm. The goal, “To assist community banks by providing an SBA financing alternative to business clients, while leveling the playing field between community banks and their larger regional bank competitors.”

Joe is a seasoned financial services sales executive. He has originated and funded in excess of \$225 million in SBA loans over the last 17 years as a VP – Senior Business Development Officer with 2 national SBA lenders. He was an original member of the sales team that successfully attained recognition as the number one SBA lender in the nation for 12 years. Joe can be reached at joe.wojtowicz@bizloanfunding.com, or 330.219.1423.

Dave Nighswander joined BizLoanFunding.com shortly after its inception. He began his career in banking, where he spent 16 years as a commercial lending VP. He has been a founding member in 5 start-up companies providing non-traditional lending solutions to community banks and their clients. He has consulted with community banks and small business throughout his career. Dave can be reached at dave.nighswander@bizloanfunding.com, or 419.732.3174.

More information about the company can be found at

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