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FINANCIAL LENDING NOTES

LENDING STRATEGIES

It's Time to Give SBA Loans a Second Look

While it doesn't always feel like it, the United States has officially been out of recession for three years now. And with economic growth (how-ever slow it has been) has come growing demand for small business loans in many areas of the country.

Unfortunately, community banks sometimes face the challenge of trying to create a lending package for businesses that can best be described as the "walking wounded." Many such businesses managed to survive the recession by aggressively managing receivables and inventory, and delaying replacement capital expenditures.

Now that the economy is in recovery, these businesses need to rebuild working capital in order to fund new receivables and inventory, and fill new orders. However, many no longer qualify for traditional bank loans or lines of credit due to strained liquidity, high leverage, deteriorating collateral and/or excessive losses.

Without some sort of external cash infusion, companies in this situation will eventually fail due to a lack of capital. But what can you, as a commercial lender, do to help them if they don't meet your standard underwriting guidelines?

Rethinking SBA Loans

One solution many community banks are now turning to is the U.S. Small Business Administration (SBA). The primary objective of the SBA is to help banks make loans to businesses they normally wouldn't be able to lend to based on normal small business underwriting standards.

If your first thought when you hear "SBA loans" is "cumbersome, expensive and not worth the effort," you should think again. In recent years, SBA loan programs have been restructured, making them powerful financing tools that, in the right circumstances, can meet the needs of a broad range of small businesses — including the walking wounded.

For starters, the SBA loan application process has been streamlined and simplified, with less documentation now required on the part of borrowers. And the *Small Business Jobs and Credit Act of 2010* increased the loan limits for SBA 504 and 7(a) loans:

- The maximum loan amount for regular 504 loans was increased from $1.5 million to $5 million, while the maximum loan amount for 504 loans made to small manufacturers and certain energy efficiency projects was increased from $4 million to $5.5 million.

- The maximum loan amount for 7(a) loans was increased from $2 million to $5 million.

In addition, the definition of a "small business" for SBA loan purposes was broadened. Any company that has a tangible net worth of less than $15 million and two-year average net income of less than $5 million may now qualify for an SBA loan. See the box below for more details on the primary types of SBA loans.

Lucrative Funding Vehicles

Besides enabling community banks to help companies that don't meet more restrictive internal small business underwriting guidelines, SBA loans can also be lucrative funding vehicles for banks. The margins and fee income can be healthy, and by selling the SBA-guaranteed portion of the loan in the secondary market, your bank can loan this money back out to other small businesses, either traditionally or via more SBA loans.

Of course, you can hold the SBA loan in your bank's loan portfolio instead. This may enable you to leverage your capital and reduce your portfolio risk,

LENDING STRATEGIES

It's Time to Give SBA Loans a Second Look, cont'd.

since the SBA-guaranteed portion of the loan features lower (20 percent) risk-based capital requirements.

When making SBA loans, there's one important rule of thumb you must always keep in mind: Never let an SBA guarantee lull you into making a loan that you don't think will be repaid.

Sure, an SBA guarantee can help make up for weaknesses in a credit (like the startup nature of a business, a new management team or a lack of hard assets to be pledged as collateral) that wouldn't enable you to lend to a business under normal circumstances. But it shouldn't be used to justify making a bad loan that doesn't cash flow.

Know and Follow the Rules

You should also be aware that the SBA has very strict rules and regulations in place for banks that make SBA loans, including stringent monitoring and reporting requirements. Therefore, make sure that your bank has the infrastructure and systems in place, as well as the expertise on staff, to meet all of these requirements.

Like most any loan guarantor, the SBA will likely look for a reason to deny the guarantee if problems arise. So be very careful not to give them one.

To learn more about the potential benefits of making SBA loans to small business borrowers, please give us a call at 314.862.2070.

The Lowdown on SBA Loans

SBA 504 loans – These loans provide long-term, fixed-rate financing primarily for owner-occupied commercial real estate; the purchase of long-term machinery, equipment, furniture and fixtures; and business expansion, upgrades or modernization, including the purchase of land and improvements and construction of new facilities. The SBA typically provides 40 percent of the total project cost while the bank provides up to 50 percent and the business contributes the remaining 10 percent.

SBA 7(a) loans – The most popular and flexible SBA loans, 7(a) loans can be used to finance practically any business need, including acquisition/expansion, permanent working capital, franchise financing, commercial real estate, building renovations or improvements, equipment or inventory, and partner buy-outs. Loan maturities range from 10 years for business acquisition/expansion to 15 years for equipment and 25 years for commercial real estate.

SBA*Express* loans – Minimal paperwork is required to apply for these accelerated review loans (the SBA's turnaround time for loan review is just 36 hours), which top out at $350,000. SBA*Express* loans can be issued as either term loans or revolving lines of credit.

Keep in mind that there are also job creation components with some SBA loans. For example, a business generally must create or retain one job for every $65,000 guaranteed by the SBA in order to qualify for a 504 loan. Alternatively, a business may qualify if it meets a community development or public policy goal, such as expansion of a business owned and operated by a woman or a veteran.

The SBA loan application process has been streamlined and simplified.

WEIGHING THE PROS AND CONS

Should You Participate in Participation Loans?

Many community banks rely on participation loans as a source of alternative funds for lending. Selling participation loans may enable banks to meet their borrowers' financing needs when loan amounts exceed the bank's lending capacity, whether legal or self-imposed.

Conversely, buying participation loans can help community banks grow their loan volume and diversify their portfolios. Typically, participation loans are traded between banks that have established relationships with each other.

Why Participate?

Community banks buy and sell participation loans for a number of different reasons, including:

To meet the credit needs of growing small businesses. Without participations, community banks could find themselves unable to meet a growing small business customer's credit needs — and then watch this customer leave for a larger bank that can. Participations may also enable community banks to provide a wider variety of financing alternatives to borrowers.

To build loan volume. If a bank is sitting on excess deposits but there is a lack of loan demand in its local market area, it can loan out these deposits by buying participations from other banks outside its area.

To diversify their loan portfolio. Participation loans can help diversify a portfolio by industry or geography. For example, if a bank's region is dominated by a particular industry (such as agriculture), it might consider selling participations in agriculture loans to banks in other regions, thereby preserving deposits to lend to businesses in other industries.

Similarly, if a bank's market area for making small business loans is limited to a particular radius, its portfolio could be vulnerable to fluctuations in the local economy or market conditions. Selling participation loans to banks outside this area could help spread out this risk geographically.

To lend to directors. Regulation O places limitations on how much money community banks can lend to small business owners who are on their board of directors. Participations are a way to legally lend to credit-worthy directors in excess of these limitations.

Participation Guidelines

Whether your bank is new to participation lending or has been buying and selling participations for awhile, there are some nuances you should keep in mind. Here are four participation loan guidelines to follow:

1. Be sure the participation agreement spells out the rights and responsibilities of both banks. The bank purchasing the participation should have the right to receive regular financial information from the selling bank, which should keep the buying bank regularly informed about all aspects of the credit.

Most banks have their own participation agreements, so you may need to negotiate which one to use, or create a new agreement that incorporates elements of both. All the details of the loan and the participation should be spelled out in the agreement, including but not limited to:

- Loan servicing
- Which bank assumes how much credit risk
- The rights and responsibilities of the participating parties if the loan becomes troubled

2. Make sure both banks are in agreement about credit risk ratings. There's no single accepted industry standard for risk ratings (like Moody's bond ratings) — a "3" in one bank, for example, might be a "5" in another bank. Consider using Moody's RiskCalc™ or KMV to quantify the credit risk of companies across different industries and size ranges in a consistent framework.

3. Perform due diligence on any other banks you're considering participating with, carefully examining their underwriting and monitoring processes, expertise, the historical quality of their loan portfolio, etc. The same goes for the participating bank's market area.

4. Perhaps most importantly, you should apply the same underwriting guidelines to participation loans that you do to loans your own bank originates. Also be sure to obtain a complete underwriting package from the participating bank.

Important: If certain conditions are not met in the participation agreement, a transaction will be treated as a borrowing and the loan will not be removed from the books. This is something banks should obviously try to avoid.

Accounting for OREO (Other Real Estate Owned) and Foreclosed Assets

Foreclosing on assets pledged as collateral is usually the last step a bank will take with borrowers who are delinquent in repaying their loans — but it's a step that, unfortunately, must sometimes be taken. Once foreclosure takes place, the lending relationship with a borrower effectively ceases, and the bank becomes the owner of a hard asset — an important distinction.

A foreclosed asset is defined as a loan in which the bank has received physical possession of a borrower's assets, regardless of whether formal foreclosure proceedings have taken place or a deed in lieu of foreclosure has been issued. The secured loan should be recategorized as an asset on the bank's balance sheet in the appropriate asset category, such as other real estate owned, or OREO.

Banks are required to follow certain practices when holding OREO, including:

- Maintain the property and prevent deterioration of its condition.
- Actively market the property and maintain insurance.
- Determine if any property code violations exist, or if there are any environmental issues or issues with regard to compliance with the ADA.
- Determine proper handling of income and expenses.

In addition, banks must follow a variety of different accounting and reporting standards for foreclosed assets:

- OREO is considered to be held for sale, and should be accounted for at its fair value less cost to sell. In a declining real estate environment, banks may need to order periodic reappraisals.
- The fair value less cost to sell — not the lower of cost or market (or LOCOM) — becomes the "cost" of the foreclosed asset.
- Expenses that don't add value to the property should be recognized through the income statement as incurred. Expenses that do add value to the property may be capitalized.

Call us if you have questions about accounting and reporting standards for OREO.

For more information, please contact **Mike Prost, CPA/ABV/CFF, CVA, ASA** at 314.862.2070 or mprost@muellerprost.com.