SBA Procedural Notice

TO:	All Employees	**CONTROL NO.:**	5000-1056
SUBJECT:	Small/Rural Lender Advantage Initiative	**EFFECTIVE:**	5/12/2008

Introduction

In January of 2008, the U.S. Small Business Administration (SBA) introduced in Region VIII the Small/Rural Lender Advantage (S/RLA) initiative designed to accommodate the unique loan processing needs of small community/rural lenders, many of which do not make SBA 7(a) loans or make very few SBA loans. During the course of implementing this initiative and in configuring its Standard 7(a) Loan Guaranty Processing Center (LGPC) staff and procedures, and following extensive discussions with Region VIII field staff and rural lenders, the Agency concluded that S/RLA could be further enhanced and streamlined, making it more accessible to additional small community/rural lenders. Also, as a result of discussions with field staff and lenders, the Agency found that some small lenders do not have access to Risk Management Association's (RMA's) financial data, an initial requirement for loan applications under S/RLA, which limited these lenders' ability to participate in S/RLA.

As a result, SBA is streamlining and simplifying the lenders' S/RLA loan application requirements through this procedural notice, which replaces in its entirety SBA Procedural Notice 5000-1045, published January 8, 2008. However, these enhancements will not change or reduce the credit analysis performed by SBA's LGPC. The changes are summarized as follows:

- SBA has simplified and reduced the number of tiers used by lenders to identify the information that must be submitted to SBA with an S/RLA loan application from three tiers to two tiers, with the first tier comprising loans of $150,000 or less and the second tier comprising loans greater than $150,000 up to $350,000. (See below discussion of tiers.)
- SBA will not require the use of RMA data by lenders. SBA will generally use RMA benchmarks along with credit scoring and other analytics in its analysis of S/RLA loans, so lenders with access to RMA may benefit from considering RMA data in their credit analyses.

Key Features of S/RLA Initiative

The S/RLA initiative is part of a broader SBA initiative to promote the economic development of local communities, particularly those facing the challenges of population loss, economic dislocation and high unemployment. It is a component of the Agency's 7(a) loan guarantee program and is designed to encourage small community/rural lenders to partner with SBA by simplifying and streamlining the Agency's application process and procedures, particularly for smaller SBA loans. The key features of S/RLA include:

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- A 7(a) product designed exclusively for new or small SBA loan volume lenders submitting loan requests through a non-delegated lender process.
- A product developed to increase the number of small lenders that make SBA loans and increase the number of loans processed by these small volume SBA lenders.
- Training and counseling assistance for new and/or small volume SBA lenders provided by SBA field offices on the Agency's 7(a) loan policies and procedures.
- Support and assistance for non-SBA lenders from SBA field offices on how to become an SBA lender.
- Maximum loan limit of $350,000.
- SBA's standard 75/85 percent guaranty applies: SBA will guarantee 85 percent of a loan for $150,000 or less and 75 percent of a loan above $150,000.
- Centralized and expedited SBA processing with routine loans processed within 3-5 days.
- Lenders to transmit applications via fax and eventually via a web-based application.
- Fillable PDF loan application which, when signed, may be faxed or e-mailed to SBA. (Signed original must be maintained by lender.) S/RLA PDF form available at: http://www.sba.gov/tools/Forms/smallbusinessforms/fsforms/index.html
- Simplified SBA loan eligibility questionnaire to help small or new SBA lenders to understand SBA's eligibility requirements.
- Specialized eligibility assistance through the LGPC for eligibility questions and more complex eligibility issues.
- A help desk to support lenders participating in this initiative.

S/RLA Participation Limited to Small SBA Volume Lenders

As noted above, small community/rural lenders have unique needs that limit their participation in SBA's highly streamlined and delegated loan programs, which is why S/RLA has been expressly designed to address those needs. However, by requiring SBA's review and determination of a loan's creditworthiness and eligibility, it is less efficient for SBA (and for some lenders) than the SBAExpress or PLP platforms, which better facilitate the needs of more experienced and larger volume lenders. A significant shift of these loans to S/RLA could have a significant impact on SBA's limited staffing resources as well as significant implications for the Agency's subsidy rate.

As a result, during the initial roll-out phase, SBA will limit the use of the S/RLA initiative to smaller SBA volume lenders located in Region VIII (that are in good standing with SBA) that have processed an average of 20 or fewer SBA loans annually over the last three fiscal years or, if non-SBA lenders, have been approved by SBA to participate in the 7(a) loan guarantee program. S/RLA lenders that progress to processing more than an average of 20 loans annually for three years will be encouraged to transition to one or more of SBA's delegated lender programs – SBAExpress and/or the PLP program. The LGPC, which will process all S/RLA loan applications pursuant to the procedures discussed below, will screen each application to ensure it is complete and meets SBA's requirements, including the requirement that the lender had processed an average of 20 or fewer SBA loans annually over the last three years. The LGPC will request that any lender that has processed more than an average of 20 SBA loans (anywhere) annually over the last three years and any lender located outside Region VIII resubmit that application using standard 7(a) procedures or through one of SBA's delegated lender programs.

In implementing and testing this new streamlined concept, SBA intends to also assess its feasibility as the foundation of a new loan application and new loan process for all 7(a) loans that would require less information for smaller sized 7(a) loans (whether processed through standard 7(a) procedures or PLP) with appropriately more information and analysis required for larger and/or more complex SBA loans.

Small/Rural Lender Advantage was designed not only for small volume SBA lenders, but also for lenders not currently participating with SBA. While non-SBA lenders interested in participating with SBA must meet certain Agency requirements and must apply for authority to make SBA loans, support and assistance are available from SBA field offices on how to become an SBA lender. (A lender may request assistance and/or apply for SBA loan making authority through its Lead SBA Office, which is usually that district office in closest proximity to the lender's headquarters, or lenders may contact the LGPC.)

SBA field offices will provide training and counseling assistance for new (as well as small volume) SBA lenders on the Agency's 7(a) loan policies and procedures, including loan processing, servicing, and liquidation procedures. In addition, SBA's loan processing, servicing, and liquidation service centers will provide instructional and support materials as well as help desks to assist new and small SBA lenders to assimilate and conform with SBA's requirements. Information is also available for lenders at the two following web sites. (Non-SBA lenders will want to pay particular attention to SOP 50-10(5) at the second web site, which describes how a lender can become an SBA participant.)

- http://www.sba.gov/aboutsba/sbaprograms/elending/reg/
- http://collab.sba.gov/sops/Documents/5010/sop50105.pdf

The Agency will introduce and initially test this initiative with those small SBA volume lenders (lenders averaging 20 or fewer SBA loans per year for three years nationwide) and qualified non-SBA lenders whose main bank address is located in SBA's Region VIII, which comprises the following states: Colorado; North Dakota; South Dakota; Montana; Utah; and Wyoming.

Loan Application Procedures for S/RLA

In streamlining its loan application process for S/RLA, the Agency has re-engineered its loan application and its loan processing requirements and procedures to reduce the complexity of and paperwork associated with smaller SBA loans. This has been accomplished by developing and adopting new analytical loan processes and procedures, including business credit scoring, which limit the information required by SBA to reliably and effectively analyze the credit risk associated with an SBA loan application, especially for smaller loans, and increasing the amount of information required by the Agency commensurate with any increase in loan size, complexity, and/or risk. (Loan complexity or risk is generally related to the size of the loan; age of the business; certain financial factors, which are addressed in this section; and to the eligibility of the loan, which is addressed in the next section.)

Significant streamlining under this concept will also be accomplished by allowing lenders to submit to the Agency their internally generated credit memoranda in lieu of certain traditional SBA required documents, such as business and/or personal financial statements, appraisals, etc. However, SBA is requiring that the lenders' internal credit memoranda meet reasonable and prudent industry standards and that, as the size and/or complexity of the loan increases, certain additional information must be included in the memoranda. SBA also may, at its discretion, require additional information from lenders beyond that described below, including where ambiguous eligibility issues are involved.

As a result of its reengineering efforts for this initiative, SBA has restructured its 7(a) loan application requirements for S/RLA into two loan tiers, generally delineated by the size of the loan, but also dependent on certain complicating factors, with the higher tier requiring additional information. The two tiers for S/RLA (for loans of $350,000 or less) are discussed below. Loans above $350,000 will continue to require SBA's standard Form 4 and Form 4-I application as they are not part of the S/RLA initiative.

The two tiers described below for submitting S/RLA loan applications up to $350,000 are based on input from the lending industry as to how it approaches underwriting similar loans of this size and the Office of Capital Access's assessment of what is needed to best evaluate credit risk. In addition to the use of credit scores, credit information compiled by RMA on industry characteristics will generally be utilized by SBA in making a credit determination. (While SBA is making the use of RMA data optional for lenders, lenders with access to RMA may want to continue to use RMA data comparisons in their credit analyses, which will promote a better understanding of SBA's analytics and its credit standards.) This initiative also requires a more comprehensive underwriting of loans to start-up companies (those in business for less than two years) and loans involving changes of ownership.

In addition to restructuring S/RLA, SBA has also redesigned and streamlined its loan application and has also added an eligibility questionnaire to assist lenders with borrower eligibility assessments. The new application and the questionnaire (SBA Form 2301, Parts A, B, and C) are located at http://www.sba.gov/tools/Forms/smallbusinessforms/fsforms/index.html.

Loan Application Requirements for Tier 1 Loans:

This tier includes all loans of $150,000 or less except for the following, which require the lender to follow the procedures for Tier 2 loans:

1. New businesses (in business for two years or less) and changes of ownership.
2. Businesses that have had judgments or bankruptcy filings.
3. Businesses with a debt service coverage ratio of less than 1**.**2**:**1 to include all existing and new debt. (Debt service coverage is defined as projected net profit after taxes (for 12 months after loan approved) plus depreciation, interest, and amortization divided by all existing and new debt service.)

For Tier 1 loans, the lender must submit SBA Form 2301, Parts A, B, and C as well as the lender's credit memorandum. The credit memorandum must meet reasonable and prudent industry standards, including, at a minimum:

- Description of the history and nature of the business.

- Analysis/calculation of cashflow relative to debt service: Show how historical cashflow would cover total debt service after the SBA loan. (Lenders may use "rule of thumb" cash flow, defined as earnings before interest and taxes, plus depreciation and amortization, less total debt service. Each component (including total cash flow) must be shown.)
- Description of and comments on the business plan including: 1) Management experience of principal(s), particularly in the industry; 2) Financial condition of the business; and, 3) Nature of any competition.
- Spread of Business Balance Sheet to include requested loan funds and any required equity injection (as of date of loan disbursement).
- Ratio calculations (based on the Balance Sheet/Income Statement) for the following financial ratio benchmarks: Current Ratio, Debt/Tangible Net Worth, Debt Service Coverage, and other ratios the lender considers significant for the business/industry (inventory, receivables, payables, etc.).
- Collateral adequacy assessment (using liquidation values) to offset risk of default.
- Explanation of and justification for the refinancing of any debt as part of the loan request, particularly Same Institution Debt.
- Discussion of credit analysis, including lender's rationale for recommending approval.
- Any additional information the lender considers relevant to the credit decision.

<u>Loan Application Requirements for Tier 2 Loans:</u>

Defined as loans between $150,001 and $350,000 PLUS loans to the following:

1. New businesses (in business for two years or less) and changes of ownership.
2. Businesses that have had judgments or bankruptcy filings.
3. Businesses with a debt service coverage ratio of less than 1.2:1 to include all existing and new debt.

The lender's Credit Memorandum for Tier 2 loans must include (at a minimum) the items required for Tier 1 loans plus the following:

- Analysis of working capital adequacy to support projected sales growth in next 12 months.
- Analysis/calculation of cash flow relative to debt service: (1) Show how historical cashflow (if appropriate) covers debt service after SBA loan (Same as Tier 1); and, (2) Show how projected cashflow covers debt service after SBA loan. (May use rule of thumb cashflow.) Also, provide an analysis of the reasonableness of the assumptions supporting the projected cashflow.
- Discussion of any: 1) Seller financing; 2) Stand-by agreements; 3) 90+day delinquencies; and/or, 4) Trade disputes.
- For a change of ownership, discussion/analysis of business valuation (based on generally accepted valuation methods used for the pertinent industry) used to support the purchase price.
- Discussion of any bankruptcy filings or judgments.

<u>Standard 7(a) Loan Guaranty Processing Center's Credit Analysis</u>

In addition to the S/RLA lender's credit memo, the LGPC will use a validated business credit scoring model known as "Liquid Credit," other credit scoring methodologies, credit reporting service information, and additional generally accepted financial analysis tools and ratios (including cashflow analysis) to analyze S/RLA loans, with the level and sophistication of SBA's credit analysis increasing as the size (tier) and/or complexity of the loan increases. (SBA will not decline any loan due to a weak credit score.) However, in contrast to the streamlined two tiers used for lender loan applications, SBA's internal analytical processes will be segmented into three tiers: (1) Loans of $50,000 or less; (2) Loans of $50,001 up to $150,000; and, (3) Loans above $150,000 up to $350,000.

For loans of $50,000 or less, the LGPC will rely more heavily on credit scoring but also will conduct additional credit review/analysis, including a review of the cashflow, with the level of that analysis potentially increasing as appropriate depending on the credit score and other particulars of that application. For loans of $50,001 up to $150,000, the LGPC will credit score the loan (the credit score threshold will generally be higher than for loans of $50,000 or less), but the LGPC will perform additional credit analysis and will more heavily weigh this additional analysis. For loans above $150,000, the LGPC will assign significantly less weight to the credit score while more heavily weighing and more comprehensively analyzing the SBC's credit characteristics, including the balance sheet and pro formas; income statement, including forecasts and trends; operating ratios; cashflow; etc, including analyzing the additional information that S/RLA lenders must provide for Tier II loans. As appropriate, SBA will compare these data and ratios to industry averages/standards from RMA or from other established financial sources.

S/RLA Eligibility Determinations

Some loans may involve complicating eligibility factors, such as affiliates, refinancing, citizenship, excessive personal resources, etc, that will require additional information and possibly discussion between SBA and the lender and/or applicant. As a result, under S/RLA, the Agency will provide participating lenders specialized support and assistance in assessing an applicant's eligibility. This includes an enhanced Eligibility Questionnaire (SBA Form 2301, Part C), which will help lenders quickly and easily assess most applicants' eligibility for an SBA loan.

The Questionnaire has been established to address each eligibility issue with a declarative statement which, for the applicant to be immediately eligible, must be answered with a "True" by the lender based on the information the lender must obtain from the applicant. In some cases, the only choice is "True," otherwise the applicant/business would be deemed ineligible. The lender may want to discuss such situations further with the LGPC.

In most cases, a choice between "True" and "False" has been provided. In those cases where "False" is chosen, there may be a complexity or a potential conflict with SBA's eligibility standards which will require additional information and possible discussion with the lender, so lenders should contact the LGPC at 916-735-1515, ext 4368, or forward its issue/question to **7aquestions@sba.gov** for additional guidance. **However, to expedite handling, lenders should review and complete the entire questionnaire for the applicant/business before contacting the LGPC.** Also, additional information on SBA's eligibility requirements is available at **www.sba.gov/aboutsba/sbaprograms/elending.**

The lender and/or applicant must answer each question on the questionnaire, and the applicant and the lender each must sign the questionnaire. (SBA Form 2301, Part C) In addition, the applicant must complete and sign Part A, SBA Form 2301, Applicant's Application for Guaranty, and the lender must complete and sign Part B, SBA Form 2301, Lender's Application for Guaranty. The lender must send Parts A, B, and C of SBA Form 2301 to the LGPC at 6501 Sylvan Road; Citrus Heights, CA 95610 or fax to (916) 735-1680.

SBA Will Assess S/RLA Initiative

After introducing, testing, and refining this initiative in Region VIII, the Agency may expand the initiative to additional geographic areas as appropriate. In making a recommendation to expand beyond Region VIII, the Office of Capital Access will conduct a preliminary analysis of the initiative but, due to the relatively short time frame anticipated before expansion, that analysis will have some limitations. However, as the initiative/loans mature, SBA will complete a more comprehensive analysis of its performance and impact, as described below.

In the near term, SBA's initial analysis of the initiative will consider the following:

- Number of loans processed through initiative.
- Potential volume compared to budget limitations.
- Findings and recommendations from Region VIII District Directors, including their perception of small lenders' reception and usage of facility.
- OCRM portfolio analysis and projections based on L/LMS.
- Evaluation of distribution of credit scores for loans approved.

A comprehensive evaluation of the initiative will be possible after about 18-24 months of operation and will consider:

- Number of loans processed through initiative.
- Increase in small lenders participating with SBA.
- The number and percent of SBA loans generated by small lenders.
- Number of and increase in SBA loans to rural communities.
- Delinquency, purchase and loss rates compared to other SBA loan products.
- Subsidy implications of Initiative compared to other SBA loan products.
- OCRM portfolio analysis and projections based on L/LMS.
- Evaluation of lending decisions that override credit score cut-off (either approved or declined).
- Loan performance, but with recognition of limitations due to age of portfolio.
- Evaluation of need for additional analysis for start-up businesses based on comparison of credit decision recommended by credit score and actual credit decision based on additional analysis conducted.
- Comparison of loans approved under traditional underwriting practices with those approved as part of this initiative to validate changes in underwriting criteria used and to identify any adjustments needed to initiative.
- Evaluation of distribution of credit scores for loans approved.
- Credit scores compared to actual delinquency, purchase, and loss rates.

However, and as noted above in the discussion on credit analysis, SBA will also closely monitor other aspects and segments of the loans approved under this initiative and routinely assess the appropriate threshold level for acceptable credit scores. Annually SBA will validate the credit scoring models to ascertain their predictiveness relative to this portfolio of SBA guaranteed loans. In addition, SBA will evaluate certain segments of the loans approved, for example start-up businesses, and will make appropriate adjustments to its analytical methodology, including acceptable credit scores and information and analysis required from lenders.

Questions regarding this notice may be forwarded to gail.hepler@sba.gov or charles.thomas@sba.gov.

Grady B. Hedgespeth
Director, Office of
Financial Assistance