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# The Problem with SBA Loans ...

Seren Funding Corp.

Tel: 800.961.9486

Web: [www.serenfunding.com](http://www.serenfunding.com)

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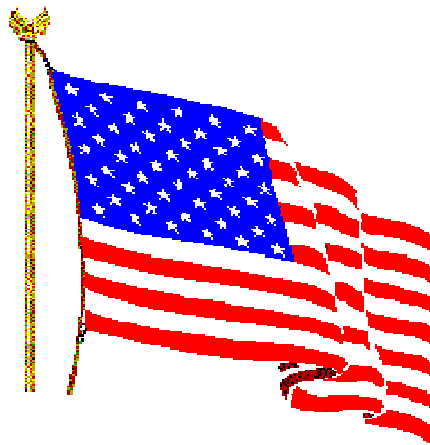
There's no doubt about it. The Small Business Administration (SBA) has assisted millions of small businesses since its launch in 1953. In the last decade alone, the SBA helped more than 435,000 businesses with nearly \$95 billion in financing.

But the truth is, the SBA is not for every small business owner. In several instances the time and energy spent pursuing government programs can be more productively spent in the private sector where business moves faster with fewer encumbrances.

Though this latter point seems to be a knock against the SBA, it's not meant to be. In fact, any difference in speed and degree of difficulty associated with SBA financing is recognition of the significant and unique hurdles the agency faces in conducting its business.

Specifically, with taxpayer dollars at risk, federal regulators must take every possible precaution to protect them. In addition, they must take all possible steps to ensure universal access. Imagine the protest if SBA sponsored financing was channeled to one specific industry and experienced substantial losses. These two constraints, combined with common misperceptions of the agency held by borrowers and entrepreneurs, often conspire to make SBA financing challenging for the business borrower.

For instance, contrary to popular belief, the Small Business Administration is not a direct lender and does not lend money. The SBA's cornerstone financing program, the so called 7(a) program, provides banks that make loans to small businesses a guarantee on a portion of the principal. If you default, the government will repay the bank. This guarantee, or protection of principal, motivates lending that might not otherwise occur, and as a result funnels debt capital to small business.



And while the economics of this arrangement make sense, they result in a two-tiered application process. The first application is made to the lending institution, typically a bank, (though not always), and then another application is made to the Small Business Administration for the guarantee. And of course, a two-tiered application process results in a two-tiered approval process. While both parties work hard to respond fast, the reality is that two approvals can often take longer than one. For businesses with fleeting opportunities, there can be a real cost associated with delay.

In addition to potential delays with the approval process, the disbursement processes associated with SBA guaranteed loans can result in further delays and additional documentation. Specifically, in most instances, the agency requires lenders to make loan proceeds checks co-payable to the borrower, and the borrower's payees. While this represents prudent processing on the part of the SBA, for borrowers trying to fund a project where costs may be constantly changing, nailing them down at a moment in time can represent a complex and time consuming challenge.

Next, there is a common misconception that SBA will finance projects or businesses that are very risky, and unfundable by traditional lenders, because they are the government and the government can afford to lose money. While the concept of entitlements has significant currency inside of the federal govern-

ment at large, it has almost none inside of the Small Business Administration.

Because of the public policy constraints faced by the SBA, the underwriting standards look very much like those of a conventional lender. First, SBA lenders are not collateral lenders, but cashflow lenders. Repayment from the cash flow of the business is a primary consideration in the SBA loan decision process. And like any other lender, if cashflow dries up, the SBA is looking for appropriate collateral behind the loan. Though the agency can often work with situations where collateral might be thin, SBA loans require a guarantee from all principals with a stake of more than 20% in the business enterprise. In addition, this guarantee carries a lien on the borrower's property. Translation: If you default and the SBA pays the guaranteed portion of your loan principal, the agency can go after your personal property and assets to make it whole again.

The fact is the SBA is not in business to assume a great deal of risk. In truth it can't because the agency wasn't built that way. It's for this reason that the Small Business Administration has turned down guarantees on loans that lenders have approved.

Finally, SBA-guaranteed loans are not cheap. While the federal government subsidizes a wide range of activities and constituencies, small business is not one of them. The Small Business Administration charges its lenders a guarantee fee which the lenders can, and often do, pass onto the borrowers. For loans of more than \$150,000 up to and including \$700,000, a 2.5 percent guaranty fee is charged. For loans greater than \$700,000, the guarantee fee is 3.5 per-cent. For loans greater than \$1,000,000, there is an additional up front guarantee fee equal to 0.25 percent of the amount by which the guaranteed portion of the loan exceeds \$1,000,000. In addition, if a

commercial loan in a combination financing has a senior credit position to the 7(a) loan, a one-time fee equal to 0.7 percent of the amount of the commercial loan is charged to the borrower.

In addition to guarantee and servicing fee, the Small Business Administration charges a so-called subsidy recoupment fee for prepayments of more than 25% during the first three years of loans with 15 year maturities or more. Subsidy recoupment fees range, starting at 5% of the prepayment and fall to 1% over time.

These fees, in addition to an annual servicing fee of 36 basis points, can have a material impact on a borrower's effective

interest rate on their loan, and in some instances the company's overall cost of capital.

It's important to point out that none of the requirements or underwriting standards established by the Small Business Administration are unreasonable. They are established to protect taxpayer dollars, a must. However they should very reasonably cause borrowers with fundable deals to carefully consider their sources. While the SBA may offer an alternative, lenders that do not offer SBA-guaranteed loans are unencumbered by the constraints on a federal agency, and as a result may be better positioned, and more nimble in servicing your unique borrowing needs.

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Seren Funding Corp is a Commercial Lender specializing in Stated Assets / Stated Income mortgages. To discuss a loan scenario please call 800.961.9486.