

SBA May Save the Day

Although it has witnessed a decrease in loan volume, this government program can still help small businesses

By **Jeff Rauth**, president, Commercial Finance Advisors Inc.

THIS PAST YEAR WAS A TOUGH ONE for the commercial mortgage industry. Numbers were down across the board as lending slowed.

The slowdown included U.S. Small Business Administration (SBA) loans, as well. In fiscal year 2008, SBA-approved loans fell 29 percent from fiscal 2007, according to the SBA. Plus, their combined loan value dropped by about 13 percent in the same period.

For commercial mortgage brokers who work with SBA loans, it helps to know the potential reasons for the recent decline. With this understanding, brokers can better determine whether SBA loan programs will suit their small-business clients' needs.

Many industry players were surprised by the SBA-loan-volume decrease. After all, the government set up the program in 1953 in part to help small businesses by providing the kind of high-leverage loans that most traditional banks wouldn't offer.

There were some supply-and-demand issues, however, that caused banks to curb even their SBA-lending activities. These are the issues brokers must understand to help their small-business clients determine whether SBA loans are right for them.

Fees and costs affect demand

There are three key issues that affect borrowers' demand, contributing to the slowdown in SBA-loan closings.

First, SBA loans are relatively expensive in terms of fees when compared to conventional loans. The 7(a) loan program's guarantee fee, for example, can be as much as 3.75 percent. The 504 loan program, which small-business own-



ers often use for real estate, has fees of around 3 percent, according to the SBA.

From a broker's perspective, selling a 3-percent guarantee fee — which the lender often passes on to the borrower — is not easy. Some owner-user borrowers who have nowhere else to go for high-leverage, low-interest-rate financing will even forgo SBA financing because of the fee. This occurs despite the fact that the fee often is rolled into and financed with the loan amount.

As market realities settle in, however, this fee may once again seem a reasonable cost for getting a high-leverage loan.

Second, interest rates factor into many borrowers' decisions to forgo SBA financing. For instance, the 7(a) program's quarterly adjustable

rate scares some borrowers as they contemplate where the prime rate might go. Some hard-money borrowers, for example, would rather pay double-digit rates than refinance into an adjustable-rate loan.

The issue for many of these borrowers is that they don't want to have to refinance their loan now and again in a few years — not to mention paying the third-party costs and fees again.

This strategy may make sense if investors come back and start buying commercial loans on the secondary market soon. But brokers and their borrowers must consider whether that is likely, given current market conditions.

With all the cheap assets available to investors today, it may take a while for them to see the value in commercial mortgage-backed securities.

A more reasonable way to look at the 7(a) variable rate may be to consider the fact that the prime rate is at a historic low. If your client received a 7(a) loan when the prime is near 4 percent, it would take three years of quarterly 25-basis-point increases to get the prime rate to 7 percent. At that time, the declining 5/3/1-percent prepayment penalty would have expired, and your client can refinance into a better rate, if it's available. If a better rate is not available, your client can stay in the 7(a) loan for as many as 22 more years, given that 7(a) loan terms for real estate can be for as many as 25 years.

The third issue involves the SBA's new standard operating procedure (SOP), which took effect this past August. While the SBA reduced the size of its SOP, it also reduced the required loan to value (LTV) for most special-use-property purchases from 85 percent to 80 percent. This is delaying many planned purchases because borrowers must build up their cash to meet the new requirement.

The SOP also requires gas stations that are more than five years old to obtain a Phase II environmental site assessment and indemnification agreements. Many borrowers wishing to finance gas stations that are older than five



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years are therefore looking for other financing options.

Supply issues

There also are supply-side liquidity issues on the part of banks that have affected SBA loan volume. Typically, banks that fund SBA loans intend to sell the debt into the commercial secondary market. If they don't do this, they must account for the full loan balance in their reserves.

By selling the guaranteed portion of the loan, banks need only account for the remainder in their reserves. For example, if the SBA guaranteed 75 percent of a 7(a) loan, the bank would need only account for 25 percent in its own reserves. This gives the bank higher liquidity and more money for lending. Now that the secondary market has few buyers, however, more banks are finding that they must portfolio their loans — something they never intended to do.

A big reason that demand for SBA 7(a) loans has fallen in the secondary market is that many market investors have their funding sources tied to the London Interbank Offered Rate (LIBOR). And LIBOR has increased dramatically against the prime rate to which most SBA 7(a) loans are tied. When the LIBOR is 4.3 percent and prime is 4 percent, for example, it no longer makes sense for foreign investors to purchase securities linked to the prime rate.

The SBA has recognized this problem. This past November, it started to allow banks to use the one-month LIBOR plus 3 percent, in addition to the prime rate, as the loan's base rate. This change should help to eliminate the LIBOR/

prime spread issue and allow more banks to sell these loans on the secondary market.

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Despite these supply-and-demand issues, SBA loans are still available to small-business owners, and banks are still providing them.

Try getting your small-business clients a carwash, restaurant or hotel loan with straight conventional financing at any reasonable LTV — it probably won't happen. With limited options for conventional lending for high-leverage loan requests, brokers likely will find the SBA to be the funding choice for many owner-users in today's market. **!!**