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Changes in the Credit Standards of SBA 7(a) Small Loans

As a follow-up to articles that appeared in the November 2013 and March 2014 Wisconsin Banker, I would like to address further changes in SBA's credit standards for loans of $350,000 or less. SOP 50 10 5(F) (effective 1/1/2014) identified loans of this size as "7(a) Small Loans" and established an application process and set of credit criteria that are more lender friendly and structured to encourage lenders to make lower-dollar loans. With Notice 5000-1314, the U.S. Small Business Administration (SBA) announced further revisions to Standard Operating Procedure (SOP) 50 10 5(F) related to the credit standards for 7(a) Small Loans. These changes, which went into effect July 1, 2014, do not extend to the SBA Express and Export Express programs.

As a part of their effort to streamline and reduce costs of delivery for the 7(a) Small Loan program, SBA is placing more reliance on their credit scoring system and reducing repetitive requirements for the lender. SBA's credit scoring system, which has been in place for a number of years, takes into consideration a borrower's personal and business credit score, putting more weight to the business data. Based on the system's results, SBA has determined that its credit score is predictive of loan performance and going forward will play a crucial role in the determination that the business is creditworthy.

An adequate score eliminates the need for the lender to include the following factors in their credit memorandum.

1. The credit history of the applicant (and the Operating Company, if applicable), its Associates, and guarantors, including historical performance as well as the potential for long term success (character and reputation will be determined through the appropriate questions on SBA Form 1919 and, if required, SBA Form 912);
2. The strength of the business;
3. Past earnings, projected cash flow, and future prospects; and
4. The applicant's ability to repay the loan with earnings from the business.

However, even with a good score, the Lender's credit memorandum will still be needed to demonstrate reasonable assurance of repayment and must include discussion on the following points:

1. A brief discussion of the history of the business;
2. A brief discussion of the strength of the management team of the company, including the length of time the business has operated under current management and, if applicable, the depth of management experience in this industry or a related industry;
3. A brief discussion of the strength of the owner(s)/guarantor(s), including and analysis of personal financial statements consistent with lender's similarly-sized non-SBA guaranteed commercial loans;
4. Confirmation of lender's collection of business tax returns, and verification and reconciliation of the applicant's financial data against income tax data (received in response to IRS Form 4506-T, Request for Transcript of Tax Return) prior to submitting the application to SBA;
5. The lender's determination whether the equity and the pro-forma debt-to-worth are acceptable based on its policies and procedures for its similarly-sized, non-SBA guaranteed commercial loans, including the requirement for verification of any required equity injection consistent with the lender's practice for its similar commercial loans;
6. A list of collateral and its value, if the loan is secured; and
7. The effect any affiliates may have on the ultimate repayment ability of the applicant.

While SBA's new approach on the surface appears to assist in the lender's credit decision and facilitate the process, the devil is in the details. Jane Butler in her June 18, 2014 "NAGGL In Focus" article on the subject, points out that there are still "a number of questions about the intricacies of its implementation". "Most importantly, we are unsure how the new standards will sync up with SBA's continuing requirement that 'Lenders must analyze each application in a commercially reasonable manner, consistent with prudent lending standards.' That is, we do not know whether it will be acceptable for lenders to wholly rely on the SBA credit standards even if they are less rigorous than the standards that the lender uses for its similar unguaranteed loans." The National Association of Government Guaranteed Lenders (NAGGL) is monitoring the situation and will communicate SBA's position via their website and WEB*Express* sessions.