AN ANALYSIS OF THE FACTORS LENDERS USE TO ENSURE THEIR SBA BORROWERS MEET THE CREDIT ELSEWHERE REQUIREMENT

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An Analysis of the Factors Lenders Use to Ensure Their SBA Borrowers Meet the Credit Elsewhere Requirement

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INTRODUCTION

SBA loan programs are required by law to serve only borrowers who otherwise would not be able to secure loans from another source: 15 U.S.C. §636(a) states, "No financial assistance shall be extended pursuant to this subsection if the applicant can obtain credit elsewhere. No immediate participation may be purchased unless it is shown that a deferred participation is not available; and no direct financing may be made unless it is shown that a participation is not available."

Although central to SBA's mission that lenders serve borrowers who are not able to receive loans, there has been relatively little analysis of the extent to which lenders actually comply with the credit elsewhere requirement. This report presents such information collected through interviews with representatives of 23 commercial bank lenders that originate both SBA and conventional small business loans (the sample lenders). Based on the results of these interviews, this report documents the types of factors that the sample lenders use to recommend a loan with an SBA guaranty (SBA loans) and how these factors are consistent with the requirement that SBA loan recipients could not obtain credit elsewhere.

As detailed below, all of the sample lenders were selected from a frame based on information provided in call reports, and so are depository institutions. As a result, the sample lenders do not include any non-depository lenders or small business lending companies (SBLCs), which hold approximately 20 percent of all outstanding SBA loans (SBA 2005). Therefore, the findings reported here may not be generalizable to non-depository lenders if they do not use the same factors to identify borrowers who are offered SBA loans as do depository lenders.

SBA'S CREDIT ELSEWHERE REQUIREMENT

To ensure that SBA programs only serve such borrowers, lenders that originate SBA-guaranteed loans under either the 7(a) Loan Guaranty Program or the Certified Development Company (CDC) 504 Loan Program must certify that the borrower would not have received "credit elsewhere."

The SBA formally defines the credit elsewhere requirement as follows:

> SBA provides business loan assistance only to applicants for whom the desired credit is not otherwise available on reasonable terms from non-Federal sources. SBA requires the lender or CDC [certified development companies] to certify or otherwise show that the desired credit is unavailable to the applicant on reasonable terms and conditions from non-Federal sources without SBA assistance, taking into consideration the prevailing rates and terms in the community in or near where the applicant conducts business, for similar

> purposes and periods of time. Submission of an application to SBA by a lender or CDC constitutes certification by the lender or CDC that it has examined the availability of credit to the applicant, has based its certification upon that examination, and has substantiation in its file to support certification. (SBA 2000, 11)

A borrower may be certified by a lender as having met the credit elsewhere requirement if the only alternative loan that is available without the SBA guaranty has rates and terms that are not the same as those associated with the guaranteed loan. SBA's Standard Operating Procedure (SOP) 50-10(4)(E) clarifies the Code of Federal Regulations further as to the non-Federal sources that the lender must consider in making a credit elsewhere' certification. Per that SOP, alternative sources include

- The lending institution,
- The internal resources of the applicant concern,
- The external resources of the applicant concern, and
- The personal resources of the principals of the applicant concern (SBA 2000: 11).

To the extent that the applicant can acquire financial assistance from any of the above four sources on reasonable terms, the lender cannot originate a loan with an SBA guaranty. This definition, then, expands the types of applications that meet the credit elsewhere standard: (1) borrowers who could otherwise receive a loan, but on terms that are not reasonable, and (2) lenders who cannot make a loan, even with the same terms due to policy and liquidity restrictions.

Reasonable Terms

A lender may substantiate that a borrower meets the credit elsewhere requirement if that borrower could not receive a loan without the guaranty with reasonable terms. In general, loans are defined as having reasonable terms if they are originated with a loan amount, amortization period, and interest rate that are within the repayment ability of the borrower (SBA 2000,12-2).

In determining whether an alternative loan is reasonable, the lender may analyze the expected debt service requirement with respect to the borrower's expected cash flow. To the extent that the expected debt service coverage ratio (the debt service divided by the expected cash flow) approaches 1.0, the lender may determine that the alternative loan is not reasonable, and so can certify that the borrower meets the credit elsewhere test. Moreover, a lender may determine that an alternative loan is not reasonable because it requires the borrower to provide an "overabundance" of collateral such that it diminishes the borrower's ability to collateralize future borrowings.

A loan may be certified as meeting the credit elsewhere requirement if the borrower requires a loan with a longer maturity than conventional loans provided by the lender. In addition, a lender's policy may preclude originating conventional loans to new ventures, or to firms in a particular industry (SBA 2000, 12).

In addition to examining the debt service coverage ratio of alternative loans, lenders may certify that a borrower meets the credit elsewhere test when the alternative loan is either a balloon note, where the loan does not fully amortize over its term, or a demand note, where a lender may call the note (accelerate the maturity date) at its own discretion. According to SBA's SOP 50-10(4)(E), both of these loans are unreasonable (SBA 2000, 14–14-1).

Lender Policies and Liquidity Restrictions

Lenders may substantiate that a loan meets the credit elsewhere standard if the borrower fails to meet the underwriting standards established by the lender for a conventional loan. For some lenders, this determination will be made by analyzing a loan applicant with an automated underwriting system that calculates a credit score. To the extent that a lender establishes minimum credit or collateral standards, borrowers who fail to meet that threshold may only be offered a loan with an SBA guaranty.

Small business credit-scoring models are becoming more prevalent, especially for small business lines of credit less than $100,000.[1] As such, some lenders may have relatively straightforward rules regarding the types of borrowers that are eligible for conventional small business loans. On the other hand, many lenders—especially smaller lenders—continue to use relationship underwriting, whereby an account representative is responsible for working with a small business customer in order to provide the most appropriate types of financing, given the firm's expected cash flow from operations. In such circumstances, it is unlikely that there is an objective threshold across borrowers who meet a lender's conventional underwriting standards. Yet, SBA allows the lender discretion to substantiate that a borrower, in the lender's opinion, has factors relating to credit that cannot be overcome except for the guaranty (SBA 2000, 12-1).

In addition to assessing whether a borrower can receive a loan on reasonable terms without an SBA guaranty, a lender may certify that a borrower meets the credit elsewhere requirement in the event that the lender does not have the available capital or liquidity without the SBA loan guaranty. In this case, a loan could be certified as meeting the credit elsewhere standard without regard to the borrower's creditworthiness or alternative loans provided by other lenders. According to the SBA's Office of Financial Assistance,

[1] For a discussion of small business underwriting, and the use of credit scores, see: Temkin and Kormendi, 2003.

> …an otherwise eligible small business, that is denied a loan solely because its bank is in an illiquid position, is fully eligible to receive an SBA guaranty. Under this premise, an otherwise creditworthy borrower is eligible to receive the guaranty if the lender has insufficient funds to make the loan; must sell the major portion in the secondary market; and, must have an SBA guaranty in order to effect the sale. In addition, SBA has always ruled that a guaranty is eligible if needed to approve a loan amount beyond the bank's legal lending limit for an otherwise creditworthy and eligible borrower. (SBA 1995, 3)

By allowing liquidity constraints as a factor that can substantiate a lender's credit elsewhere certification, the SBA acknowledges that loans with an SBA guaranty are more easily sold into a secondary market than conventional small business loans. Indeed, there is a relatively liquid secondary market for the guaranteed portion of SBA loans; this stands in contrast to the relatively small secondary market for conventional small business loans. This may change as more conventional small business loan applications are assessed with automated underwriting systems that provide objective measures of risk that facilitate creating relatively homogenous pools of conventional small business loans (Temkin and Kormendi 2003).

The findings suggest that the lenders are aware of the credit elsewhere requirement and adhere to the requirement. In many cases, the sample lenders originate SBA loans to borrowers who need longer repayment terms in order to meet their debt service coverage ratio requirement. Lenders often have dedicated staff who market small business loans to prospective clients and who typically recommend SBA loans to borrowers based on their understanding of the bank's underwriting standards. Underwriters who review loan applications are generally responsible for selecting a factor that substantiates a borrower meets the credit elsewhere requirement.

PREVIOUS RESEARCH ON LENDERS' COMPLIANCE WITH THE CREDIT ELSEWHERE REQUIREMENT

The only previous research that directly examines the extent to which lenders comply with the SBA's credit elsewhere requirement was completed in 1995. In that study, the SBA's Office of Inspector General surveyed SBA field managers and loan specialists regarding lenders' adherence to the requirement between 1992 and 1994. SBA (1995) concluded that small business lenders submit a total of between $244.5 and $316 million of loans that do not meet the credit elsewhere requirement. This finding is an estimate that was based on the proportion of SBA staff responses who said that lenders "seldom" or "never" adequately address the credit elsewhere requirement (SBA 1995, 10). It is not clear why SBA regional managers and loan specialists approved such loans, although the report suggests that lenders would not participate if the rule were strictly enforced and that high quality loans are needed to keep loss rates from

rising. Based on these findings, SBA took steps to improve the industry's understanding of the credit elsewhere requirement.

A study conducted by Warden Associates and Price Waterhouse (1998) analyzed the results of a survey of SBA borrowers, who were asked if they could have received credit elsewhere without the SBA loan guaranty. Of the firms surveyed, 56 percent of respondents said that they could have obtained credit elsewhere if not for their SBA 7(a) loan. Of these 56 percent of respondents, about 19 percent indicated that the non-SBA financing would have been no different from the loan with the SBA guaranty. On the other hand, about 50 percent of all respondents said that the alternative financing would have been with a higher interest rate (Warden Associates and Price Waterhouse 1998).

Neither of these two studies are based on information provided by SBA lenders regarding the credit elsewhere requirement. One study, however, conducted by the GAO (1996) included an analysis of the results of a survey of 61 SBA lenders regarding (among other topics) their reasons for offering loans with an SBA guaranty. While not a direct examination of credit elsewhere knowledge and compliance, the report does find that that lenders typically participate in SBA's 7(a) program so that they can provide credit to start-up firms, businesses without established credit histories, and firms that do not have sufficient equity to qualify for conventional loans (GAO 1996, 41). This finding suggests that lenders use SBA loans to qualify borrowers who do not meet conventional loan guidelines, and so meet the credit elsewhere requirement.

Some studies analyze the differences in borrower/firm characteristics between SBA and conventional loan recipients; the results of these studies can be used to indirectly infer whether or not lenders are complying with the credit elsewhere requirement. Consistent with the idea that lenders do comply with the requirement, Haynes (1993), using data from the National Survey of Small Business Finances, found that high-risk firms had a higher probability of receiving SBA-guaranteed loans than low-risk firms. A GAO study (1996, 27) found that "…7(a) borrowers are similar to their non-7(a) counterparts in terms of their businesses' organizational form, the economic sector they are part of, the average number of employees, and the gender of the primary owner(s), but differ somewhat in terms of their average sales and assets, their geographic distribution, the ethnicity of the primary owners, and the likelihood of being a new business."

METHODOLOGY

To assess the extent to which lenders comply with the credit elsewhere requirement, we interviewed representatives of 23 banks that originate both SBA and conventional loans. These sample lenders were selected with the following methodology.

The Urban Institute developed the sampling frame from commercial bank Call Report data[2] that includes the total number and dollar volume of small loans to businesses as of June 30, 2004.[3] The data included ratios of loans to small businesses to (1) total assets and (2) total commercial and industrial loans.

From the population of 7,678 commercial banks, we selected a sample of 73 institutions. In order to ensure response from the largest small business lenders, the ten largest small business lenders, as measured by small business lending dollar volume, were included in our sample. These ten lenders, not surprisingly, are among the largest US commercial banks, each with over $50 billion in total assets.

However, community lenders account for 44 percent of the total dollar volume of small business lending in the United States.[4] The remaining sample, 63 firms, was drawn from banks with assets below $1 billion. In proportion to their share of small business lending, 18 banks with assets greater than $500 million and less than $1 billion, and 45 banks with assets greater than $100 million and less than $500 million were selected. As the lending environment may vary depending on local economic conditions, we selected these 63 community banks across the nine Census divisions, seven from each division.[5]

To ensure that regional lenders contacted for discussions originated SBA loans, prior to the sampling, we used SBA administrative data to determine the SBA guaranty portion of the bank's overall small business lending volume. Only those lenders that originated at least three SBA-assisted loans for the targeted programs in the past year were included. This process ensured that key informants were knowledgeable about SBA lending and reporting requirements.

Each of the 73 sampled banks was contacted twice by letter and an average of two times by telephone. Twenty-three banks responded and agreed to be interviewed. Interviews were completed with lenders following an U.S. Office of Management and Budget–approved discussion guide.[6] Guided discussions were typically conducted with the person primarily responsible for managing small business lending and lasted approximately 30 minutes.

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[2] An expanded list of lenders was accessed from data provided by the SBA Office of Advocacy at http://www.sba.gov/advo/research/2004.html.

[3] All national, state member, and insured nonmember banks are required to submit Call Report data quarterly to the Federal Reserve Board, Federal Financial Institution Examination Council (FFIEC).

[4] *Ibid*. Table G, pg. 8.

[5] The nine Census divisions are: New England, Middle Atlantic, East North Central, West North Central, South Atlantic, East South Central, West South Central, Mountain, and Pacific.

[6] The discussion guide is included as Appendix B. Office of Management and Budget approval was required in accordance with the Paperwork Reduction Act.

Of the 23 completed discussions, seven respondents were large national lenders and 16 were community banks. Regional lender respondents were distributed across seven of the nine Census divisions. For an assessment of the sample selected and respondents by asset size and geography, see Appendix A.

SMALL BUSINESS LENDING PRODUCTION PROCESS

Sourcing

The process that lenders use to attract loan applicants is called "sourcing." The sample lenders commonly receive most of their small business loan applications through one of two channels: (1) sales staff who are responsible for serving businesses located within a particular geographic region or (2) staff who are located in retail branches and serve walk-in customers who are seeking small business loan products. For most sample lenders (without regard of their size), a branch network is the base of operations for sales staff to serve a particular region. Within a branch, many lenders have staff trained to serve commercial customers, including assisting them during the loan application process. One of the sample lenders does not have a branch network. Instead this lender, based in the Midwest, serves customers by providing a courier service that takes deposit and processes them in a central office.

Unlike for residential mortgages, the sample lenders typically do not rely on brokers to attract small business loan applicants or close loans on their behalf. Rather, small business customers nearly always interact with a bank employee whose job is to work with a prospective applicant to select a loan product that, within the bank's lending and underwriting policies and standards, best serves the customers needs. Some sample lenders receive referrals from other banks that do not offer SBA products, or from commercial realtors who are showing properties to small business clients. Both types of these applicants account for a small share of the sample lenders' applicant pool.

The above sourcing methodology means that most small business loan applicants work face-to-face with a sample lender's representative, who determines whether a borrower should apply for a conventional or SBA loan. It is not common for potential applicants to specifically request a conventional or SBA loan; rather, they contact the lender about a financing need and work with him/her to find the most appropriate product.

The sample lenders said that their staff are trained to be knowledgeable about the company's underwriting requirements. In fact, some sample lenders allow branch managers to make credit decisions regarding small business loan applications. Some sample lenders restrict this authority for loans below a particular threshold. The sample lenders oftentimes have dedicated staff that underwrites SBA loan applications. In many cases, staff will contact such

SBA underwriters in order to determine if a prospective applicant should apply for a conventional or SBA loan.

Underwriting

The process and factors that sample lenders use to evaluate loan applications is the same whether a borrower is seeking a conventional or SBA loan. For each type of application, underwriters often pull a credit report or credit score for each principal of the business requesting the loan; in addition to requiring the applicant to provide income statements, a balance sheet, and *pro forma* projections regarding the business.

In some cases, sample lenders used an automated scoring system to reach a credit decision, but this type of underwriting was often restricted to loans below a particular threshold amount. For example, one lender said that loans for less than $100,000 are autodecisioned with an algorithm that evaluates the principal's credit score and a business score provided by Dun and Bradstreet. Another lender used an automated underwriting system developed by Baker Hill, a company that develops and provides software-based small business loan origination solutions.

Rather than conduct automated underwriting, the sample lenders said that nearly all conventional and SBA loan applications are evaluated through manual underwriting, which takes into account an applicant's cash flow, credit history, collateral, character, and equity contribution. The sample lenders said that, in general, they do not follow any "hard and fast" rules when making a credit decision, although there are some general guidelines that influence a credit decision.

Many sample lenders characterized themselves as "cash flow" lenders who placed greatest weight on an applicant's ability to repay a loan, rather than the type of collateral or equity contributed by a borrower. As one lender's representative said, "collateral doesn't pay debt, it liquidates debt." Consequently, sample lenders stressed that applicants had to demonstrate, either from previous years' financial statements or reasonable projection, that their business generated sufficient cash flow for debt service.

Sample lenders typically require that the debt service coverage ratio (DSCR), which is calculated by dividing the applicants net operating income by the annual debt service (including the requested loan), be at least 1.20. In addition, most sample lenders did not make loans to borrowers with a loan-to-value ratio greater than 80 percent. And, while credit scores were not

used as a sole determinant in the credit decision, some sample lenders said that they would be unlikely to approve a loan for an applicant whose credit score was below 620.[7]

In addition to these general guidelines, sample lenders evaluated the type of collateral that was being used by applicants to secure the loan. Sample lenders said that some collateral, such as a unique type of machinery used by a particular business, was likely to be difficult to sell in the event of a foreclosure. Loans to purchase such equipment hence represented a higher level of risk than one to be used to purchase equipment that was not as business-specific.

The lender underwriters use all of the above information to determine if an applicant is an acceptable credit risk. This decision may be influenced by the applicant's existing relationship with the bank; the particular loan application is often evaluated using information about the performance of other loans made to the company and its use of other lender services. This loan evaluation process described above is consistent with the findings of other analyses of small business lending, which reports that many small business loan applications are evaluated with the use of financial statement, asset-based or relationship underwriting (e.g., Berger and Udell 2001).

DETERMINANTS OF CONVENTIONAL VERSUS SBA LENDING

Sample lenders' small business loan production processes are largely dependent on sales staff or branch-based bankers who discuss loan products with potential small business loan applicants. These staff members are familiar with the lender's general underwriting standards, and so can determine, early in the process, whether a prospective applicant is best suited for either a conventional or SBA loan product.

According to lender representatives, most SBA applicants are referred to the program for one of three reasons: (1) businesses do not show sufficient net operating income (NOI) to meet the bank's required debt service coverage ratio requirement, given the maximum available loan term; (2) the collateral offered to secure the loan is likely to either depreciate quickly or have a low resale value because it is specialized equipment; and for real estate-related loans, (3) the borrower does not have sufficient equity for the required downpayment. Each reason is discussed below.

[7] FICO scores range from between 400 and 800, and are based on a person's credit history. Higher scores are associated with borrowers who represent low credit risks.

Borrower Does Not Meet Debt Service Coverage Ratio Requirement

In general, lender representatives said that most applicants are referred to SBA loans because they cannot evidence a sufficient level of cash flow to meet a debt service coverage requirement (DSCR), which is typically about 1.2 times net operating income (NOI). It is *not* the case that sample lenders approve SBA loan applications when the DSCR is less than the requirement for conventional loans. Rather, sample lenders said that SBA loans are offered with longer terms than conventional loans since they are originated with a credit enhancement that provides up to 85 percent of the unpaid principal balance of the loan in the event of a foreclosure and so a lender's recovery upon foreclosure is not totally dependent on the proceeds from liquidating collateral.

Many sample lenders said that they did not offer conventional small business loans with a term longer than five years (except for real estate loans), while they offered SBA loans with terms as long as ten years. By offering loans with longer terms, applicants can meet DSCR requirements with a lower NOI, as demonstrated in the following table.

Figure 1. Analysis of Loan Term on Required Net Operating Income

	Conventional A	Conventional B	SBA (7a)
Loan Amount	$250,000	$250,000	$250,000
Interest Rate	7.5%	7.5%	7.5%
Term (in years)	3	5	7
Annual Fully Amortizing Payment	$93,319	$60,114	$46,015
Annual NOI required w/ DSCR 1.25x	$116,648	$75,142	$57,519

Figure 1 shows the annual payments associated with a fully amortizing $250,000 loan with an interest rate of 7.5 percent with terms of three, five, and seven years. Assuming that a lender requires a DSCR ration of 1.25x NOI, an applicant would have to demonstrate annual NOI of $117,000 in order to qualify for a loan with a three-year term, either with income statements or projections. The required NOI for a five-year term (the maximum term that many sample lenders said they offered for conventional loans) is $75,000, or only 64 percent of the NOI needed to qualify for a three-year term loan. With a seven-year term loan, a borrower needs only $58,000 to meet a DSCR requirement of 1.25x NOI, or 48 percent of the NOI required for a three-year term loan. This finding is consistent with GAO (1996) that found variable interest rate SBA loans between $100,000 and $499,999 originated with a 7(a) Program guarantee between 1991 and 1995 had an average term of about 14 years, while similar conventional loans had an average term of less than four years (Figure II.6, pg. 23).

As discussed earlier, many sample lenders indicated that an applicant's cash flow, rather than collateral was a primary underwriting factor. Sample lenders often require borrowers to document a business's cash flow with three year's worth of income statements. It is not

possible, of course, for start-up businesses to provide such documentation. Moreover, some businesses propose to use loan proceeds for expansion, and so their existing financial statements do not show sufficient NOI to meet a 1.2x or 1.25x DSCR. As a result, lender representatives said that start-up businesses were more likely than existing businesses to be offered SBA loans.

Sample lenders said that they benefit from providing SBA loans to start-up businesses, since these companies, if successful are likely to remain bank customers. Over time then, sample lenders can cross-sell services to start-up businesses as they grow and need more services or additional loans. Quite often such businesses receive conventional loans as they "mature" and can show actual cash flows that meet a lender's underwriting standards for shorter-term, conventional loan terms.

Collateral Represents Lower Potential Liquidation Proceeds

Sample lenders said that the longer terms made available to borrowers because of the SBA guaranty were a primary reason why applicants were referred to such products. The second most common reason cited by lender representatives is that applicants often want to use loan proceeds to purchase specialized collateral that is likely to provide relatively small proceeds if liquidated after foreclosure.

Sample lenders said that restaurants, in particular, required this type of equipment, and so borrowers seeking to purchase restaurant equipment are more likely to be offered SBA, rather than conventional loan products. In addition to restaurants, sample lenders indicated that businesses in other sectors, such as retail, hospitality, and medical services often required specific types of equipment that are difficult to sell upon foreclosure, and so these businesses also comprise a relatively large share of their SBA lending. Note that no sample lenders had policies that restricted SBA loans to a particular industry. The extent to which a particular industry comprises a lender's SBA volume results, in part, from the type of equipment used in a business.

Insufficient Equity for Real Estate Transactions

Sample lenders said that overall they do not have different underwriting standards for conventional or SBA applications, but that the SBA program provides an opportunity for borrowers to meet conventional underwriting requirements. The one exception is SBA's 504 Program, which provides credit enhancements for real estate-related loans. According to most sample lenders, commercial real estate loans require a borrower to finance between 20 and 25 percent of a real estate transaction with his/her own equity, and so restrict maximum loan-to-value ratios for real estate loans to between 75 and 80 percent.

Under the 504 Program, sample lenders said they will approve real estate loans with a loan to value ratio (LTV) of up 90 percent. The credit enhancement made available by the program, according to the sample lenders, allows them to serve borrowers who have insufficient equity to meet their conventional commercial real estate loan requirements.

Lender Liquidity

Only one lender said that it used the SBA program in order to increase the liquidity of loans for potential sale. All of the other sample lenders said that they have no interest in selling their small business loans or that they are able to sell them without the SBA guaranty. Sample lenders said they do not cite liquidity constraints as a factor they use to substantiate the credit elsewhere requirement.

Lenders' Use of the *SBAExpress* Program

Many of the lenders participated in the *SBAExpress* program, which allows lenders to use mostly their own forms and procedures to process loans and so provide credit decisions more quickly to applicants. In return for the authority delegated under this program, lenders agree to accept a 50 percent SBA loan guaranty, which contrasts with the Agency's traditional 75 to 85 percent guaranty (SBA 2002).

The lenders using the *SBAExpress* said that they can originate lines of credit under the program, in addition to other types of loans for amounts less than a threshold that varied from between $50,000 to $350,000. The applications taken under *SBAExpress*, according to the lenders, require less paperwork, and so can be processed more quickly and cheaply than typical SBA loan applications. Because of the relatively low loan amounts, *SBAExpress* applications are typically underwritten with an automated system. Some lenders said that they did not offer *SBAExpress* loans to more risky applicants, because they preferred to underwrite them with more information than allowed for in their company's automated underwriting system. Other lenders, however, said that they use the *SBAExpress* program to underwrite less risky borrowers, since the guarantee amount is lower than other SBA programs.

SAMPLE LENDERS' AWARENESS OF AND COMPLIANCE WITH CREDIT ELSEWHERE REQUIREMENT

To the extent that sample lenders are aware of the credit elsewhere requirement, and comply by substantiating that SBA borrowers would not have received a loan at reasonable rates and terms without the guaranty, there is likely to be relatively little overlap between borrowers who receive SBA versus conventional loans. As discussed above, sample lenders said that SBA borrowers frequently are (1) unable to meet DSCR standards without longer loan terms, which are not available without a SBA guaranty of (2) using loan proceeds to purchase equipment that

is likely to provide relatively little proceeds if liquidated. Borrowers who receive loans under the 504 Program typically do not have sufficient equity to meet sample lenders' requirement of between 20 and 25 percent equity for a commercial real estate loan.

Sample lenders in nearly every case were aware that borrowers who receive loans with an SBA guaranty cannot be eligible for conventional loans with reasonable rates and terms. Many lender representatives, when asked to define the term credit elsewhere were able to offer a working definition, but a select few were unfamiliar with the term "credit elsewhere", though not necessarily the requirement. As an example, a representative of a large national lender said that the credit elsewhere requirement means "…a borrower would not be able to secure financing…If [an] applicant can get credit elsewhere [the borrower] should not use [SBA] funds…" Another lender's representative, consistent with many other lender representatives, said that the credit elsewhere requirement is met in cases when an applicant would not be approved for a conventional loan.

Underwriters, for most sample lenders, are responsible for selecting a reason that substantiates that a borrower meets SBA's credit elsewhere requirement. Consistent with the findings discussed earlier in Section 4, lender representatives said that the inability of borrower to meet the bank's DSCR requirement for a conventional loan term is often the reason used to substantiate that the borrower meets the credit elsewhere requirement. Other reasons include a lack of operating history or insufficient collateral.

It is interesting to note that sample lenders said that a borrower's credit history was not a determinant for recommending an SBA loan to a prospective applicant. In fact, most sample lenders said that the credit scores for SBA borrowers are similar to conventional borrowers. The higher risks associated with SBA loans, then, are not the result of lending to borrowers with problematic credit histories; they result from lending to borrowers who do not have the same level of equity of conventional borrowers or who are in businesses areas that reflect more potential risk.

Lender representatives said that they are aware the SBA program should not be used to serve customers who can qualify for conventional loans. Many sample lender representatives said that, the credit elsewhere requirement notwithstanding, market pressures discourage them from offering SBA loans to customers who can qualify for conventional loans. The reason is that SBA loans typically are originated with higher fees. Consequently, sample lenders who offer SBA products to borrowers who can receive a conventional loan from another bank are likely to lose that customer's business, which is obviously not in the lender's financial interest.

Sample lenders said that the SBA programs allow them to serve borrowers who would otherwise not be able to qualify for loans. For most of these banks, the SBA program accounted for a small share of their overall small business lending volume: between three and ten percent. This is consistent with Rugy's finding that SBA loans account for a small share of the overall

small business lending market (Rugy 2006). But, while a small share of overall lending, lender representatives said that SBA loans can account for a larger share of lending to particular market niches, such as start-up companies and businesses within certain industry groups. For such companies, the SBA program is a critical source of liquidity that would likely not be otherwise available.

CONCLUSION

Borrowers are usually recommended to an SBA program business by employees that are knowledgeable about a company's small business loan underwriting guidelines. Based on discussions with a prospective applicant, lenders determine if an SBA program is best suited for that customer's needs. Underwriters typically evaluate small business loan applications without the use of an automated system, and are responsible for substantiating that an SBA borrower meets the credit elsewhere requirement. Overall, sample lenders said that that the SBA programs allow them to serve borrowers who do not meet their standard conventional underwriting guidelines and that there is little overlap between SBA and conventional lending.

The sample lenders interviewed for this study are aware of the credit elsewhere requirement and say that they only use SBA programs for borrowers who cannot meet their conventional small business loan underwriting standards. Most commonly, the businesses that receive SBA loans do not have sufficient NOI to meet the required DSCR for a loan with the maximum conventional loan term. SBA loans are offered with longer terms than conventional loans allowing borrowers to meet DSCR requirements.

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APPENDIX A

Figure 2. Lender Discussion Sample and Respondent Comparison

Lender Description	Sample (N)	Sample (Col %)	Respondents (N)	Respondents (Col %)
Total	73	100.0%	23	100.0%
Large National Lenders	10	13.7%	7	30.4%
Community Lenders	63	86.3%	16	69.6%
New England	7	9.6%	3	13.0%
Middle Atlantic	7	9.6%	0	0.0%
East North Central	7	9.6%	2	8.7%
West North Central	7	9.6%	0	0.0%
South Atlantic	7	9.6%	4	17.4%
East South Central	7	9.6%	2	8.7%
West South Central	7	9.6%	1	4.3%
Mountain	7	9.6%	2	8.7%
Pacific	7	9.6%	2	8.7%

APPENDIX B

Key Informant Lender Discussion Guide

OMB No: 3245-0357; OMB Expiration Date: July 31, 2009

Introduction

I am contacting you as part of a study that the Urban Institute is conducting on behalf of the SBA that examines the extent to which SBA loan guaranty programs are filling credit gaps for borrowers who would otherwise not be able to secure credit on reasonable terms without the SBA program. The purpose of this discussion is to collect information about (i) how your firm decides whether to offer a borrower either a conventional or SBA loan and (ii) how your firm, for borrowers that are offered SBA loans, substantiates that such borrowers meet SBA's credit elsewhere requirement.

The information you provide in our discussion will be used in the report, and will also help us to develop a lender survey that will be administered to about 60 lenders. Please be assured that we will not name any key informant or lending institution in our report: all key informants will remain anonymous. Before we begin, do you have any questions?

I. Small Business Lending Products

A. What channels do most of your small business customers use to contact your firm?

B. What types of small business credit products (i.e., lines of credit, micro loans, real estate and working capital) do you offer your customers?

C. What types of small business credit products are only available with an SBA guaranty?

D. What SBA loan guarantees, i.e., 7(a) do your customers use?

E. If applicable (We will have a list of PLP lenders from SBA): Why did your firm become a PLP?

F. How does your firm use the SBA Express program?

G. Are there certain types of firms (such as start-ups) that can only receive loans with an SBA guaranty? Why?

H. What is the overall lending volume for each small business credit product? Has this pattern changed over time?

I. What percentage of your overall lending book consists of SBA loans? Has this changed over time? What is this distribution by small business credit product?

II. Lender Underwriting Practices

A. What factors are considered by your firm when underwriting small business loan applications? What factors are most important? Why?

B. Does your firm use credit scores or other objective risk indicators in the underwriting process? Are such indicators used in underwriting all of your small business credit products? Why or why not?

1. If yes: Do you also use these risk indicators when setting loan rates and terms?

C. What factors does your firm consider in determining whether to offer an SBA loan to a customer? For example, is this determination largely based on the principal's credit score?

D. Are these factors the same for each small business credit product? Why or why not?

E. Are alternatives to 504 real estate-related loans originated by your company's commercial real estate or small business lending departments? What conventional products are similar to the 504 loans?

III. Credit Elsewhere

A. How does your firm define SBA's credit elsewhere requirement?

B. Who is responsible (underwriter, account representative, loan officer, etc.) for determining whether a borrower meets the credit elsewhere requirement?

C. What are the most common factors that are used to substantiate that a borrower meets the credit elsewhere requirement? Are these factors the same for each type of small business credit product? For each SBA program?

D. How often does your firm substantiate the credit elsewhere requirement based on your firm's lack of liquidity without the SBA guaranty that makes the loan saleable to the secondary market?

E. How does your firm assess the extent to which a loan offered to a borrower is more reasonable than any alternative loan?

F. What loan terms or prices define an unreasonable loan?

IV. Other Issues

A. What benefits do borrowers derive from the availability of loans with an SBA guaranty?

B. Do you think that there are some factors that can now be used to substantiate a borrower meeting the credit elsewhere requirement that could be eliminated without affecting small business credit? How are such factors used now to substantiate a credit elsewhere determination?