SBA'S SECONDARY MARKET

AN OPPORTUNITY TO PRESERVE LIQUIDITY AND INCREASE PROFITABILITY

By: Michael D. Ryan

As banks continue to experience interest margin compression, lenders of all types are consistently seeking ways to earn non-interest fee income. This hunger for non-interest income has created numerous secondary markets for loans – including a Secondary Market for Small Business Administration (SBA) 7(a) loans. This article provides a brief overview of the criteria required to participate in the SBA's Secondary Market; insights into the premium levels for various loan maturities and rate types; and reveals the magnitude of this market on a historical basis.

The selling of SBA 7(a) loans on the Secondary Market can provide a viable solution to increase non-interest fee income, facilitate lending to more borrowers, and increase the bank's overall profitability. Nearly all banks – particularly community banks – can benefit from participating in the SBA's Secondary Market to some degree.

> "THE SBA'S SECONDARY MARKET WAS CREATED TO PROVIDE ADDITIONAL LIQUIDITY TO LENDERS"

SBA'S SECONDARY MARKET

The SBA's Secondary Market was created to provide additional liquidity to lenders – expanding the availability of commercial credit for small businesses. In order to participate in the Secondary Market, a lender must be willing to sell the guaranteed portion of a SBA 7(a) loan utilizing SBA Form 1086, "Secondary Participation Guarantee Agreement," in order to sell the guaranteed portion of the loan. This form is a legally binding document – which must be executed by the Lender, Registered Holder (or investor), Fiscal and Transfer Agent ("FTA"), and SBA – includes the terms and conditions that govern the sale and all subsequent servicing of the loan being sold.

Much like any secondary loan market, there are various criteria that must be met in order to sell a 7(a) loan in this market. The lender must certify:

- The lender has underwritten, closed and serviced the loan in a prudent manner and in accordance with all SBA Loan Program Requirements;
- The lender will not share any premium it has received from this sale with a lender service provider, packager or other loan referral source;
- The loan is fully disbursed;
- The loan cannot be a revolving loan or line of credit facility;
- The SBA guaranty fee has been paid by the lender;
- The lender, including its officers, directors and employees, has no knowledge of a default or likelihood of a default by borrower; and
- The lender has no authority to unilaterally repurchase the loan guaranty from the Registered Holder without SBA's written consent.

SELLING A LOAN IN THE SECONDARY MARKET

There's an active secondary market for loans backed by the SBA. As a result, lenders can consistently sell the guaranteed portion of a SBA loan, increasing a bank's liquidity position and enabling community banks to issue more loans. SBA lenders can choose to offer 7(a) loans for sale to an active group of buyers in the Secondary Market after the loan is closed and fully disbursed. After going into the open market, the seller (the originating lender) will typically select a bid for the loan and complete the previously mentioned SBA Form 1086 to sell the guaranteed portion of an SBA 7(a) loan.

There are many macro-economic factors that impact loan sale premiums; however, from a loan structure standpoint, premium levels vary based on interest rate, interest rate adjustment period, term and loan size. These variables all impact the investor's ability to incorporate the purchased loan within a loan pool which is then sold at a premium to qualified investors. A loan structured with a fully priced variable interest rate (WSJ Prime + 2.75%), adjusting on a calendar quarterly basis, with the maximum allowable maturity (25 years) will yield the highest premiums available on the secondary market. Decreased interest rate pricing, fixed rate structures, odd-year loan maturities, and larger loan sizes limit or restrict the investor's ability to pool the purchased loan.

The following "Bid Grid" estimated by *Innovative Financing Solutions* demonstrates the current premium levels a bank may expect from calendar quarterly adjusting variable rate loans:

Gross Rate	P+1%	P+2%	P+2.75%
Term			
7 year	101.00%	105.40%	108.20%
10 year	103.90%	108.90%	111.60%
25 year	109.40%	114.40%	118.10%

SIZE OF THE SECONDARY MARKET

The following graph demonstrates the magnitude of SBA (7a) loan sales volume from fiscal year 2007 through 2016 (2017 data not available):

As the graph reveals, during FY 2016, 15,307 loans were sold with an average premium percentage of 10.9% above par.

BENEFITS TO THE ORIGINATING LENDER

The Secondary Market can be a key contributing force to the overall profitability of a bank, and the benefits to the originating lender go beyond earning a fee for the sale of the guaranteed portion of the loan. For example, if a bank has a $1 million 7(a) loan, it can sell off $750,000 of this loan (the guaranteed portion) at a premium in the Secondary Market, generate servicing income for the life of the loan, retain the unguaranteed portion of the loan ($250,000) on the books as an earning asset, and retain full control of the borrower relationship for future business.

The Secondary Market for SBA loans has become highly efficient and is widely recognized by many banks as a source of significant income, while simultaneously achieving the goal of long term customer retention and satisfaction.

MICHAEL RYAN IS PRESIDENT & CEO OF INNOVATIVE FINANCING SOLUTIONS, INC. HE CAN BE REACHED AT 610.733.9955 OR MRYAN@INNOVFS.NET.

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