CMBS Commentary

An updated primer on SBA lending programs

Primer

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Securitized Products Strategy
United States

Alan Todd, CFA
CMBS Strategist
BofAS
+1 646 855 6383
alan.todd@bofa.com

Mao Ding, CFA
CMBS Strategist
BofAS
+1 646 855 9968
mao.ding@bofa.com

Graham Voss
MBS Strategist
BofAS
+1 646 855 9177
graham.voss@bofa.com

Link to [Common acronyms]

The Small Business Administration (SBA)

Since its founding in 1953, the U.S. Small Business Administration (SBA) has helped small businesses that have been otherwise unable to obtain financing at commercially viable terms. The SBA has four main loan programs, each of which is tailored to meet the specific needs of a set of small-business borrowers.

The SBA does not lend money directly to small business owners. Instead, a small-business borrower applies for an SBA-backed loan at a local bank, credit union, Certified Development Company (CDC) or other specialized lender and the lender provides the actual loan to the borrower. The SBA guarantees a portion of the loan (usually between 50%-85% depending on the program), which effectively limits a lender's risk and exposure. This helps lenders gain comfort making loans that they might not otherwise.

Issuance & other characteristics

As of 4Q 2019, which was the date when all SBA data were most recently released, the SBA's loan portfolio totaled approximately $144 billion and we expect issuance of approximately $4 billion in 2020 for the SBAP program and $2 billion for the SBIC program. Because SBA pools come with a guarantee of 100% timely payment of principal and interest, loss of principal is less of a concern than is the timing of the return. Since prepayment penalties on SBA guaranteed bonds are less onerous than the typical hard lockout and defeasance found in CMBS, this holds especially true in today's environment as a considerable amount of bonds trade at premium dollar prices.

Notably, for projects approved on or after April 2, 2018, the SBA began issuing bonds collateralized by 504 loans with 25-year terms in response to requests from CDC industry members. As with the 10-year and 20-year debenture, SBA guarantees the timely payment of all principal and interest due on each 25-year debenture. The initial success of the program led the company to issue significantly more deals collateralized by 25-year loans last year, and we expect one 20-year deal and one 25-year deal will be issued each month (on the first Tuesday following the first Sunday of each month) and a 10-year deal will be issued every other month. Thus for 2020, we estimate total 25-year SBA transaction volume will be about $2.5 billion, 20-year SBA transaction volume will be about $1.4 billion, and 10-year SBA issuance will total approximately $100 million.

Investor base

Interest in SBA guaranteed bonds increased over the past several years and many institutions, including banks, insurance companies and money managers currently buy the product. Many of the bonds not only offer comparable (or wider) spread, similar average lives and better convexity than Agency MBS do, but have exhibited fairly stable spread profiles over the past several years – even as spread volatility increased among other asset classes. Finally, the guarantee of the full faith and credit of the U.S. government allows investors with limited commercial real estate or CMBS knowledge to diversify their portfolios without the inconvenience of a steep learning curve.

The U.S. Small Business Administration (SBA)

Since its founding in 1953, the U.S. Small Business Administration (SBA) has helped provide financing to small businesses that have been otherwise unable to obtain it at commercially viable terms. The SBA does not lend money directly to small business owners. Instead, borrowers apply for an SBA-backed loan at a local bank, credit union, Certified Development Company or other specialized lender and the lender provides the actual loan to the borrowers. Once the loan is made, the lenders execute certain forms with the SBA, which establish the terms under which the SBA will guarantee a loan. Although a loan may be originated concurrently with the signing of the SBA documents, in practice the lending institution may temporarily bear the entire risk until all SBA forms are executed. The SBA guarantees a portion of the loan (usually between 50%-85% depending on the program) and in doing so, effectively limits the lender's risk and exposure, which helps lenders become comfortable making loans that they might otherwise not approve.

Prior to 1984, the SBA secondary market was limited to the trading of individually guaranteed loans. With the US Small Business Administration Secondary Improvements Act of 1984, however, SBA-approved pool assemblers (institutions that aggregate individual guaranteed loans) were allowed to create guaranteed loan pools. Currently, the guaranteed portion of a loan may be sold individually or pooled with other loans. **Because investors' ownership interests in loans (or pools of loans collateralized by the guaranteed portions of loans) are 100% backed by the full faith and credit of the U.S. government, they are not only 100% guaranteed to receive the timely payment of principal and interest, but also enjoy a zero-percent risk weighting.**

The SBA facilitates financing through several major loan programs:

1. **SBA 504 Loan Program:** This program is designed to encourage economic development within communities by providing small businesses with long-term, fixed-rate financing to acquire major fixed assets for expansion or modernization. Certified Development Companies (CDCs) work with the SBA and private lenders to secure financing, which is collateralized by the assets being financed as well as a personal guarantee of the business owner.

   A '504 project' is typically structured as follows:

   a. Borrower equity of at least 10% of the project cost,

   b. A loan secured with a private lender that covers at least 50% of the project cost, and which represents the first lien and is senior to the CDC loan,

   c. A loan secured from a state or local Certified Development Company (CDC) that represents the junior lien (and is subordinate to the first lien) and covers up to 40% of the project cost (typically the 50-90% LTV slice of the project's financing). The debentures are pooled monthly via the Debenture Purchase, Pooling and Exchange Agreement between underwriters and fiscal agent and serve as collateral for Development Company Participation Certificates (DCPCs), which are issued and 100% guaranteed by the SBA.

   Loans may be made to start-ups as well as established businesses, although the amount of equity a borrower is required to contribute will be higher for a start-up. Of note, a temporary 504 Refinancing Program was established to allow small business owners to use 504 Loans to refinance up to 90% of the appraised value of available collateral. The Program, which is authorized to provide $7.5 billion in financing, allows small business owners to access excess equity in fixed assets to obtain working capital that can be used for financing eligible businesses. Although the original program ended in September 2012, it was reinstated permanently in 2015 with three modifications:

1. The Debt Refinancing Program shall only be in effect in any fiscal year during which the cost to the Federal Government of making guarantees under the Debt Refinancing Program and under the 504 Program is zero.

2. That a CDC limit its financing under the 504 Loan Program so that, during any fiscal year, new financings under the Debt Refinancing Program do not exceed 50% of the dollars the CDC loaned under the 504 Loan Program including the 504 Debt Refinancing Program during the previous fiscal year, unless otherwise waived; and

3. That the 2016 Appropriations Act eliminates the alternate job retention goal authorized by the Jobs Act for the Debt Refinancing Program. On May 25, 2016, the SBA published the Interim Final Rule, implementing the Debt Refinancing Program with an effective date of June 24, 2016, and the Final Rule for this program was published on May 7, 2018, with an effective date of June 6, 2018.

2. **SBA 7(a) Loan Program:** The SBA 7(a) Loan Program is the largest of the SBA Programs and is aimed at providing help to businesses with special requirements. The program offers government guaranties of up to $5 million on loans made by commercial lenders to borrowers that face challenges obtaining financing. Loan proceeds can be used for many purposes, including:

   d. to purchase real estate, including land and buildings,

   e. to acquire equipment, machinery, furniture, fixtures, supplies or materials,

   f. for long- or short-term capital needs,

   g. to establish a new business, or

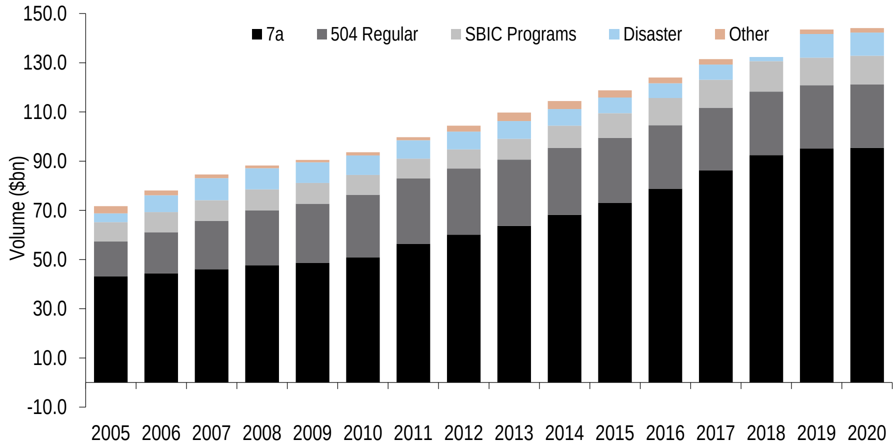
   h. to assist in the acquisition, operation, or expansion of an existing business.

3. **SBIC Debentures and Participation Certificates:** This program, which is akin to a venture capital fund-of-funds, invests long term capital in privately owned and managed investment funds. These funds, or SBICs, are licensed and regulated by SBA and use their own capital plus funds borrowed from the SBA (typically SBICs can borrow $2 for every $1 they raise) to make debt and equity investments in qualifying small businesses. A typical SBIC investment is made over a three year period and a typical SBIC loan ranges from $250k to $10 million with an interest rate between 9% and 16%. The debt capital that SBICs have access to from the SBA has a 10-year term and semi-annual debt payments. As a result of this structure, most SBICs focus primarily on providing debt financing (or debt with equity features).

4. **SBA MicroLoans:** This program is for small, short-term loans of up to $50,000 to be used for working capital or for the purchase of inventory, supplies, furniture, fixtures, machinery and/or equipment. Proceeds may not be used to pay existing debt or to purchase real estate.

As of 4Q 2019, the SBA's loan portfolio totaled approximately $144 billion, with the majority comprised of loans from the 7(a) and 504 programs (Chart 1).

Chart 1: As of 12/31/2019, the SBA loan portfolio totaled approximately $144 billion

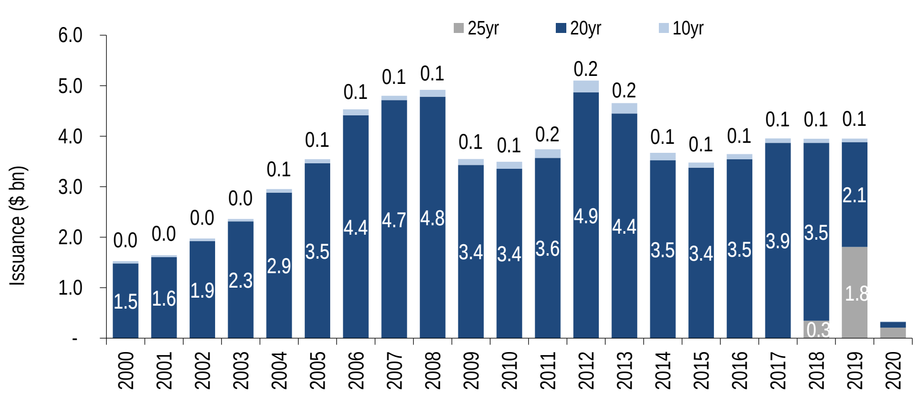


Source: BofA Global Research, Small Business Association

SBA CDC/504 Program

The CDC/504 loan program provides long-term, fixed-rate financing to small businesses that want to expand or modernize. To be eligible for a CDC/504 loan a business must operate for-profit and meet size requirements set forth by the SBA. A business qualifies if its tangible net worth does not exceed $15 million and its average net income has not exceeded $5 million after taxes over the past two years. Finally, a business may not be engaged in speculation or investment in rental real estate. **Proceeds from a 504 loan, which is collateralized by the assets being financed plus a personal guarantee from the business owner(s), must be used for fixed-asset projects, including purchasing and improving land, constructing or modernizing a facility or purchasing long-term machinery and equipment. A borrower may not utilize the 504 Program for working capital, inventory, consolidating or repaying debt, or refinancing an existing 504 loan (except for projects with an expansion component or that meet the temporary refinancing provisions of the Small Business Jobs Act of 2010).** Although 10-year loans, which are generally used to finance equipment or machinery, are available, most loans have 20-year or 25-year terms (Chart 2) and are typically used to finance real estate acquisitions.

Chart 2: Over the past decade, the majority of CDC/504 issuance has been comprised of 20-year loans; in 2019, 46% of the issuance has been comprised of 25-year loans



Source: BofA Global Research, Bloomberg

Notably, for projects approved on or after April 2, 2018, the SBA began issuing bonds collateralized by 504 loans with 25-year terms in response to requests from CDC industry members. This emphasizes small business owners' need for an affordable fixed rate instrument with a longer term to maturity. As with the

10-year and 20-year debenture, SBA guarantees the timely payment of all principal and interest due on each 25-year debenture.

The initial success of the program led the company to issue significantly more deals collateralized by 25-year loans last year, and during 2020 we expect one 20-year deal and one 25-year deal will be issued each month (on the first Tuesday following the first Sunday of each month) and a 10-year deal will be issued every other month. Thus for 2020, we estimate total 25-year SBA transaction volume will be about $2.5 billion, 20-year SBA transaction volume will be about $1.4 billion, and 10-year SBA issuance will total approximately $100 million. Investors can find CDC/504 transactions on Bloomberg by typing SBAP <MTGE> go. Deal monikers include the year in which it was issued, a hyphen, either a 10, 20 or 25, which indicates the term of the underlying loans, and a letter that corresponds to the order in which a particular deal was issued in that year. For example, SBAP 2011-20C represents the third CDC/504 transaction that was issued in 2011 with 20-year collateral.

CDC/504 loan and deal structure

CDC /504 loans are fully amortizing and have either a 10-year, 20-year or 25-year term. The maximum loan size of a CDC/504 loan depends on the criteria or community development goal that is being met. The maximum loan size is $5 million when meeting the job creation criteria (business must create or retain one job for every $65,000 in most cases) or when meeting a public policy goal (such as expansion of exports, rural development, etc.), or $5.5 million for small manufacturers (business must create or retain at least one job per $100,000 guaranteed by the SBA or achieve one or more public policy goals).

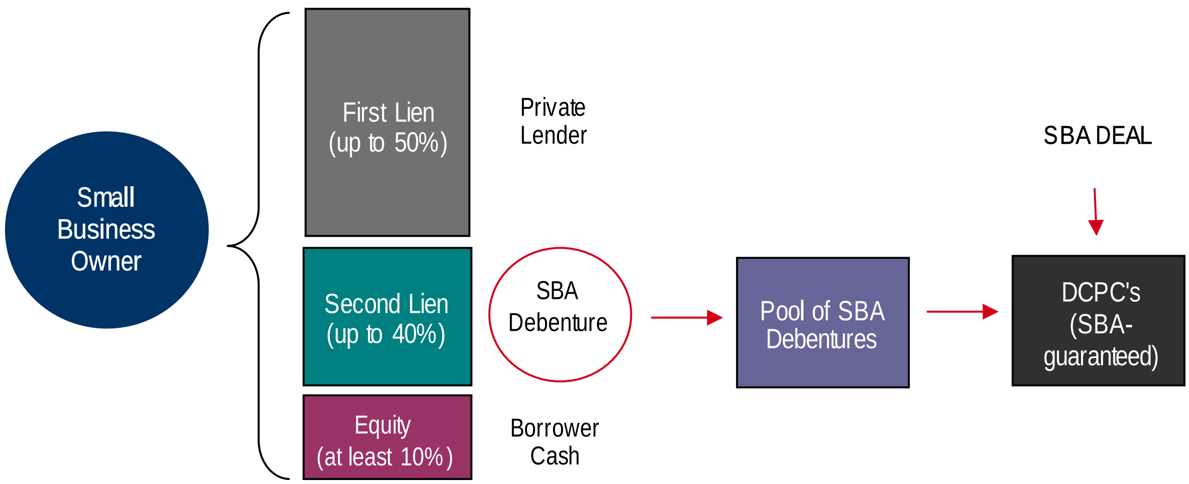
A '504 project' is typically structured as follows:

a. A cash contribution from the borrower of at least 10% of the project cost (designated as the 'borrower's equity').

b. A loan secured with a private lender that covers at least 50% of the project cost, which represents the first lien.

c. A loan secured from a state or local Certified Development Company (CDC) that represents the junior lien and covers up to 40% of the project cost (typically the 50-90% LTV slice of the project's financing). These debentures are pooled by entities known as pool assemblers and serve as collateral for Development Company Participation Certificates (DCPCs), which are issued and 100% guaranteed by the SBA (Chart 3).

Chart 3: SBA debentures are the junior lien (typically 50-90% LTV slice) of financing for SBA 504 projects; SBA debentures are pooled and collateralized as Development Company Participation Certificates (DCPCs) in SBA deals



Source: SBA

Although borrowers make monthly principal and interest payments, SBA debentures (as well as the DCPCs) pay on a semi-annual basis. A borrower's monthly note rate is derived from the semi-annual debenture rate, which is quoted as a spread over swaps. Ultimately, the borrower's gross coupon is approximately equal to the sum of 1) the debenture rate, 2) the CDC fee (which is typically 62.5bp), 3) the SBA guarantee fee (which was reduced to 32.05bp as of October 2019 for the fiscal year 2020) and the Central Servicing Agency (CSA) fee (which is typically 10bp).

Voluntary and Involuntary Prepayments

If a borrower chooses to prepay his loan, he is subject to a prepayment penalty equal, if he prepays in the first year, to the coupon of the debenture. For 10-year and 20-year loans, the prepayment penalty rate declines annually and ratably over the first half of the debenture's life. For example, a 10-year loan with a 5.0% coupon has a prepayment penalty of 5.0% of the prepaid amount in the first year. In subsequent years the prepayment penalty declines on a straight-line basis over the over the first half of the debenture's life, i.e. from a 5.0% penalty immediately to no penalty in year six (Table 1). For 25-year loans, however, the prepayment penalty rate declines annually and ratably over the first 10 years of the debenture's life (Table 2). Note that prepayments can only be made on the semi-annual payment date. **One of the advantages of DCPCs is that all prepayment penalties are passed through to SBA bondholders, and paid pro-rata on the associated semi-annual payment date.**

Table 1: Prepayment penalty schedule for a 5% coupon 10-year loan

Year	Prepayment price (% of CB)	Principal component	Prepayment premium component
1	105.00%	100%	5.00%
2	104.00%	100%	4.00%
3	103.00%	100%	3.00%
4	102.00%	100%	2.00%
5	101.00%	100%	1.00%
6	100.00%	100%	0.00%

Source: BofA Global Research

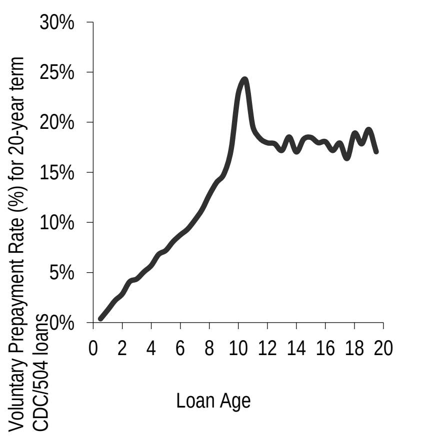
Table 2: Prepayment penalty schedule for a 5% coupon 20-year loan or 25-year loan

Year	Prepayment price (% of CB)	Principal component	Prepayment premium component
1	105.00%	100%	5.00%
2	104.50%	100%	4.50%
3	104.00%	100%	4.00%
4	103.50%	100%	3.50%
…	…	…	…
11	100.00%	100%	0.00%

Source: BofA Global Research

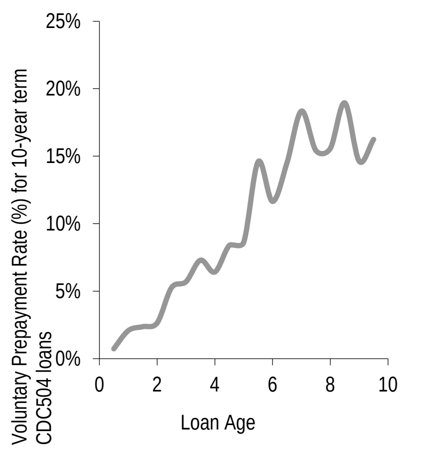
Because prepayment penalties on SBA 504 loans decline over time and eventually reach zero, borrowers are less likely to prepay during the early stages of a loan's life. Historically, the average voluntary prepayment rate ramped up during the first half of the loan term and remained at higher levels for the remainder of the term. This has been true for both 20-year loans (Chart 12) and 10-year loans (Chart 5). Given that the 25-year program initiated fewer than two years ago, the history of the voluntary prepay rate is limited (Chart 6).

Chart 4: The voluntary prepay rate for 20-year term CDC/504 loans has historically ramped up as prepay penalties decline over the first half of the loan term



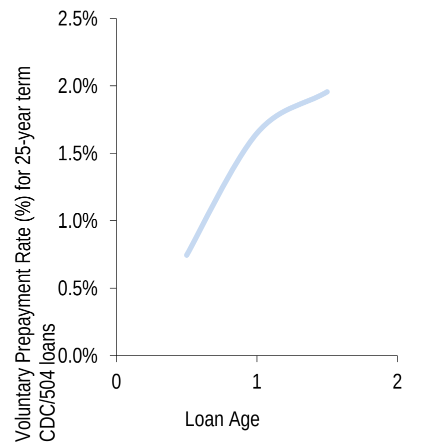
Source: BofA Global Research using Bank of New York data

Chart 5: The voluntary prepay rate for 10-year term CDC/504 loans has historically ramped up as prepay penalties decline over the first half of the loan term



Source: BofA Global Research, Bank of New York data

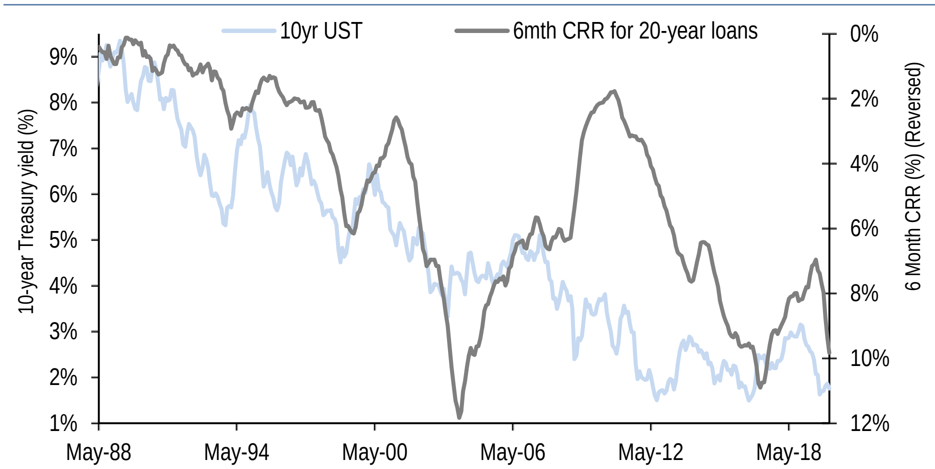
Chart 6: The history of the voluntary prepay rate for 25-year term CDC/504 loans is still limited



Source: BofA Global Research, Bank of New York data

Similar to residential mortgage products, the rate of voluntary repayments (CRR) for SBA 504 loans has historically been sensitive to the prevailing market interest rate as borrowers are incentivized to refinance into loans with lower coupons during periods of low interest rates (Chart 7).[1]

Chart 7: During normal economic cycles, voluntary prepayments accelerated following periods of declining interest rates



Source: BofA Global Research, Bank of New York data

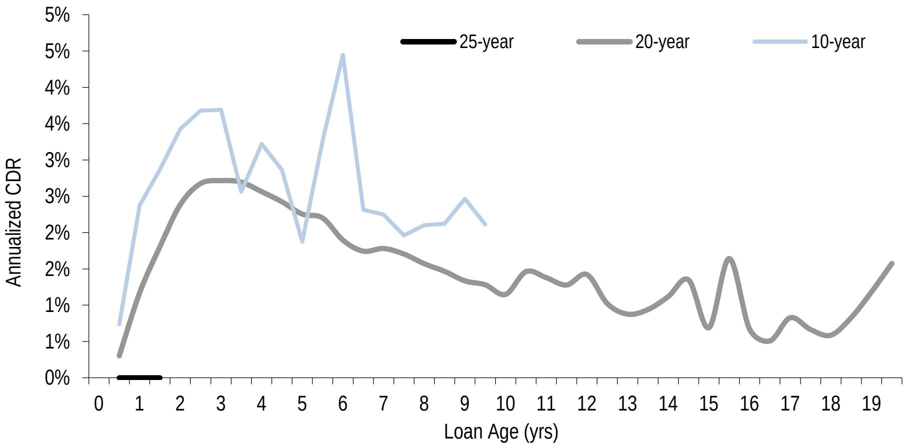
Investors in CDC/504 DCPCs are also subject to involuntary prepayments as a result of borrower defaults. In the event of a default, the SBA has two options. As the first option, it may accelerate the maturity of the debenture by making a payment of 100% of

[1] It is important to note, however, that the SBA 504 program does not allow borrowers to refinance into a new SBA loan except for projects with an expansion component or that meet the temporary refinancing provisions of the Small Business Jobs Act of 2010.

the outstanding principal amount, which is distributed pro-rata to bondholders. If the SBA does not exercise its right to accelerate the loan, its second option is to make semi-annual payments for the loan (pursuant to its guarantee).

Several factors have historically influenced SBA 504 default rates. While a cursory analysis indicates that loan defaults peak about three years after origination (Chart 8), this metric is partially skewed by the surge in issuance just prior to the financial crisis.

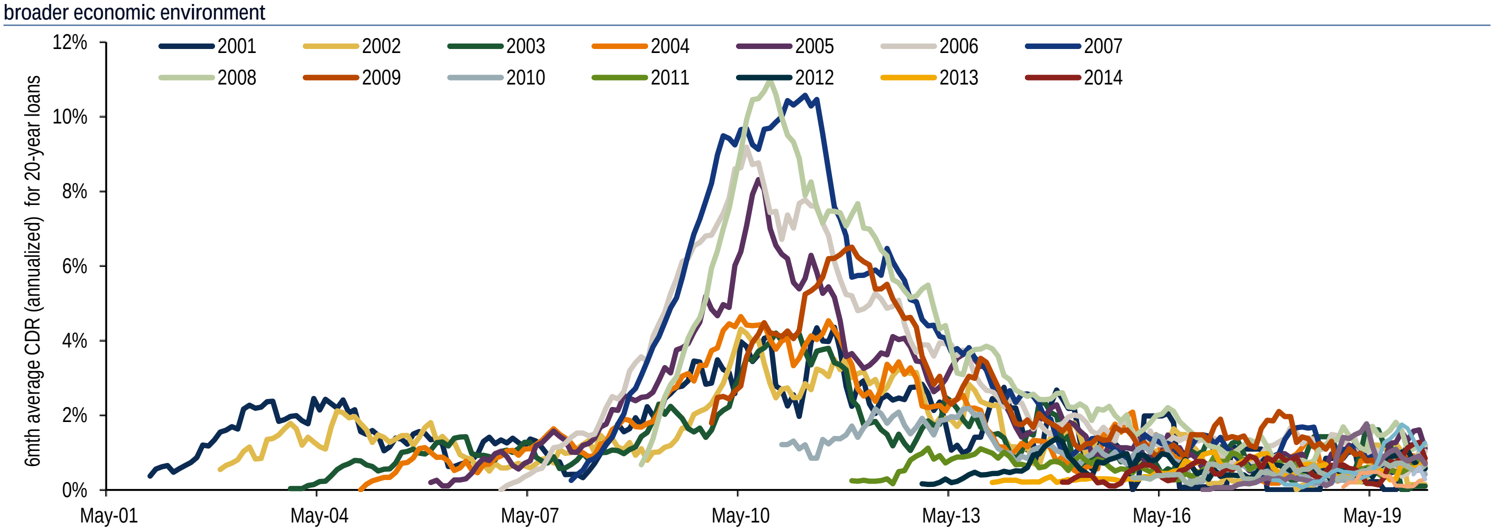
Chart 8: Historical CDR by loan age (Using all data from 1987-Present)



Source: BofA Global Research, Bank of New York data

While loan seasoning is obviously a factor in determining default probability, we believe that defaults are affected to a much more significant extent by the broader economic environment, as evidenced by the spike in default rates among SBA 504 loans in 2009-2010 (Chart 9) followed by the subsequent decline as the economic environment improved.

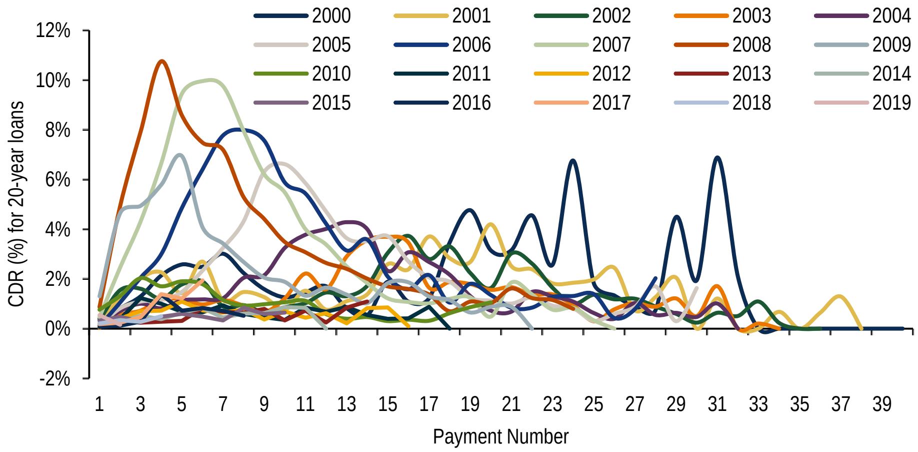
Chart 9: Default rates for 20-year SBA loans originated in 2001-2008 spiked during the financial crisis, which indicates the high correlation between loan performance and the broader economic environment



Source: BofA Global Research, Bank of New York data

This is not to suggest that loan vintage doesn't also contribute to a loan's likelihood of default. In fact, loans originated in the years (2005-2008) leading up to the financial crisis not only experienced larger spikes in defaults (to 8-10%) than did loans that were originated in 2004 and earlier and those originated post crisis (Chart 10), but realized those defaults earlier during their loan terms as well.

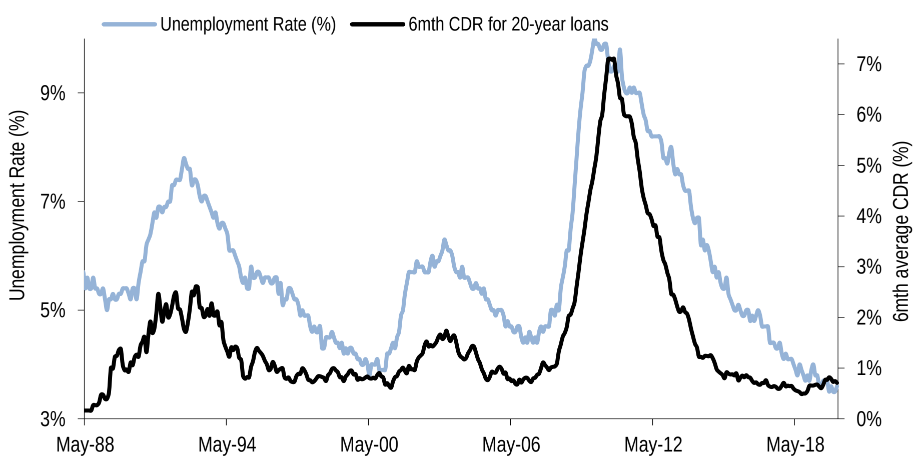
Chart 10: Loans originated into the peak of the market defaulted earlier in their lives and to a greater extent than did loans originated before 2005 or after 2009



Source: BofA Global Research, Bank of New York data

For loans originated in 2004 and earlier this is probably due to the combination that businesses collateralizing earlier vintage loans had more time to stabilize and grow prior to incurring a massive economic shock, underwriting standards were more conservative before 2005 and the fact that the loans had time to amortize some of the outstanding balance. Post crisis loans, on the other hand, experienced a broad economic expansion, which was bolstered by low interest rates and falling unemployment rates. In fact, over the past 25 years, default rates for the universe of SBA 504 loans have very closely mirrored trends in the national unemployment rate (Chart 11).

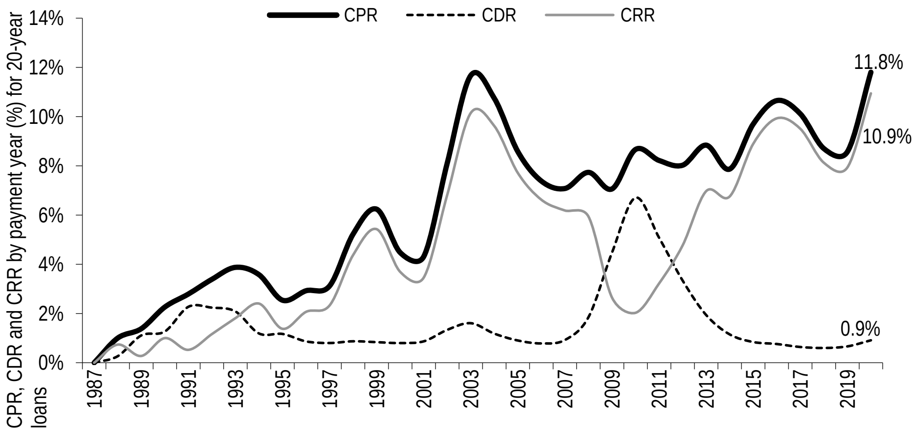
Chart 11: CDR rates for SBA 504 loans closely mirrored the national unemployment rate as weaker economic conditions fueled more defaults



Source: BofA Global Research, Bank of New York data

Analyzing the history of involuntary (CDR) and voluntary (CRR) prepayments for loans that securitize 20-year CDC/504 DCPCs we found that whereas voluntary prepayments may have been driven by falling interest rates, default rates appeared to be caused by slowing economic growth and rising unemployment (Chart 12).

Chart 12: Voluntary and involuntary prepayments for 20-year CDC/504 loans



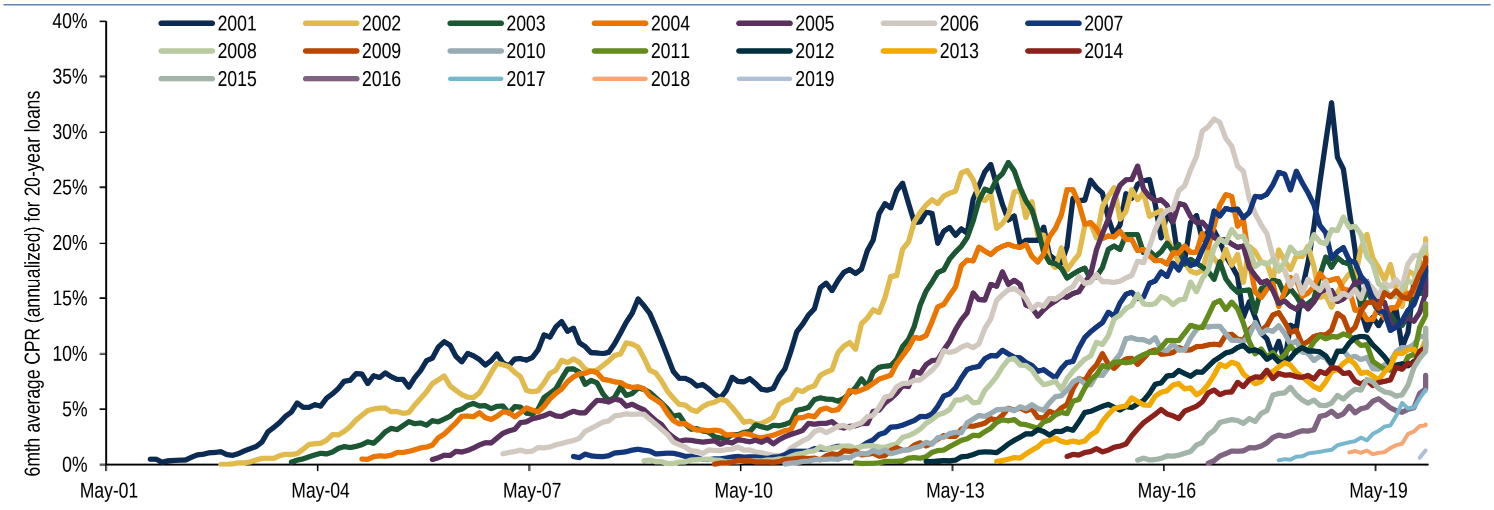
Source: BofA Global Research using Bank of New York data

SBA 504 Pricing & Trading Convention

At issuance, both 25-year bonds, which have a roughly 9-year average life, and 20-year bonds, which roughly have an 8-year average life, are quoted as a spread to the 10-year swap yield. 10-year bonds, which have an average life of just shy of 5 years, are quoted as a spread to the 5-year swap yield. After that, as bonds trade in the secondary market, convention is for them to be quoted at a 5% CPR as a spread to the part of the swaps curve that matches their average life.

Despite the 5 CPR pricing convention, bonds have actually paid considerably faster over the past few years due to the combination of low interest rates and an improving economy. In fact, following the recession, voluntary prepayment speeds across almost all vintages increased markedly (Chart 13). All else equal, if this trend continues investors may realize lower yields than a 5 CPR pricing convention implies given most SBAP bonds trade at premium dollar prices.

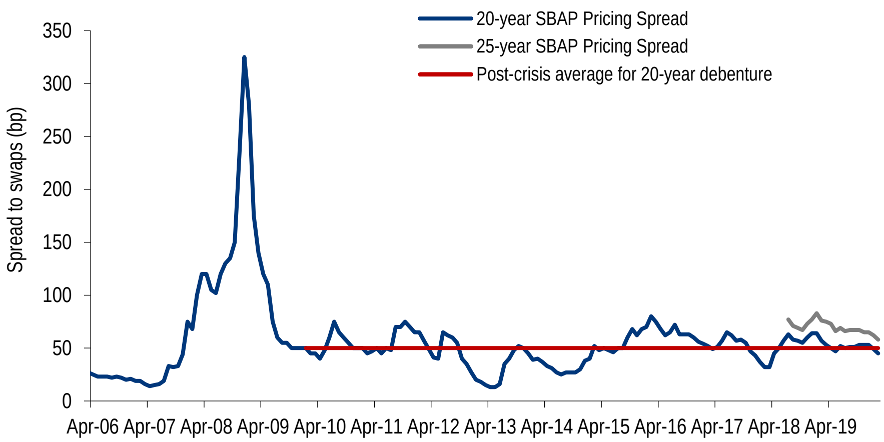
Chart 13: Default rates for 20-year SBA loans originated in 2001-2008 spiked during the financial crisis, which indicates the high correlation between loan performance and the broader economic environment



Source: BofA Global Research, Bank of New York data

The latest 25-year SBAP deal, which priced in February 2020, did so at S+58bp, which is 13bp wider than the level at which the most recent 20-year deal priced (Chart 14).

Chart 14: Since 2010, the average SBAP 20-year debenture pricing spread has been 50bp over 10-year swaps; 25-year debenture has priced at about 12-15bp wider than 20-year debenture



Source: BofA Global Research

In general, over the past few years 20-year SBAP pricing levels have been rangebound between S+50bp and S+80bp. Although the 25-year SBAP WAL is roughly one year longer than that of 20-year SBAP paper, an investor can currently pick up about 13bp (Table 3).

Table 3: 25-year SBA 504 bonds currently offers wider spreads and potentially a more stable cashflow profile than competing investments do

Product	Spread to swaps (bp)	WAL	Maturity
25-year SBAP	S+63	~9 years	25 years
20-year SBAP	S+50	~8 years	20 years
Freddie K A1	S+51	6.5-7 years	10 years
7/6.5 DUS	S+48	6-7 years	7 years
FNCI 2.5	S+68	~4.5 years	15 years

Source: BofA Global Research

SBA 7(a) Program

The SBA’s 7(a) Loan Program is its primary program to help start-up and existing small businesses obtain guaranteed financing for a variety of general business purposes including the acquisition or expansion of an existing business. The SBA generally does not specify what businesses are eligible. Rather, the agency outlines what businesses are ineligible.[2] Most American banks participate in the program, as do some non-bank lenders, which expands the availability of loans. Participating lenders agree to structure loans according to SBA's requirements, after which they apply for and receive a guaranty from the SBA on a portion of this loan.

Within the 7(a) program, there are four major sub-categories:

- **Express Program:** Offers streamlined and expedited loan procedures for particular groups of borrowers including those located in underserved or distressed communities, or those that are controlled by veterans or members of the military community.

- **Export Loan Program:** Designed to help small business exporters, which is defined as those businesses with 20 or fewer employees.

- **Rural Lender Advantage Program:** Designed to accommodate small community/rural-based lenders. The program promotes the economic development of local communities, particularly those facing challenges of population loss, economic dislocation, and high unemployment.

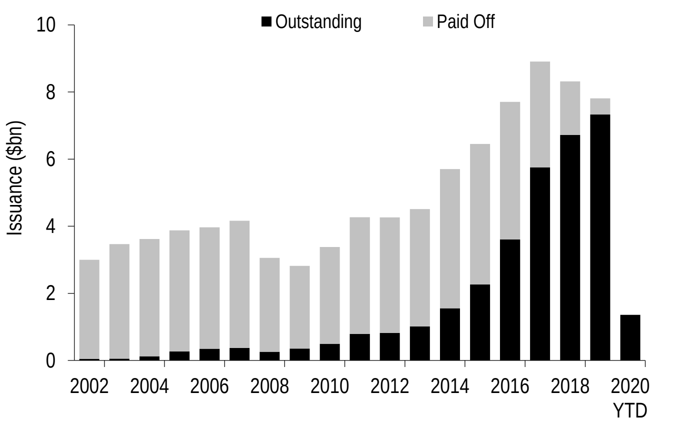
- **Special Purpose Loan Program:** Designed to help businesses that have been impacted by NAFTA, to provide financial assistance to Employee Stock Ownership Plans, and to help implement pollution control mechanisms.

While the specific terms of SBA loans are negotiated between borrowers and lenders, 7(a) loans are typically originated up to a 90% LTV with the SBA guaranteeing as much as 75% on loans of more than $150,000, 85% on loans up to $150,000 and 90% on international trade loans. The SBA’s maximum exposure per loan, however, is $3.75 million. The remainder of the debt is retained by the originator and any recovery after a default is divided between the lender and the SBA proportionally. To increase liquidity, the guaranteed portions of SBA loans are pooled by entities known as pool assemblers and sold to investors. Note that the SBA bears any risk of default – not the bond holder – and investors’ ownership interests in these pools of loans collateralized by the guaranteed portions of loans are 100% backed by the full faith and credit of the U.S. government.

In aggregate approximately $90 billion of pools of adjustable rate 7(a) loans have been issued. As of this writing about $34 billion remains outstanding (Chart 15), and loans with terms greater than 10 years comprise over 90% of this (Chart 16).

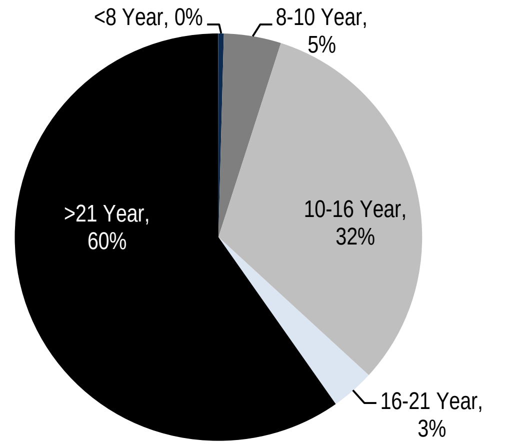
[2] Detailed loan eligibility requirements can be found at: https://www.sba.gov/loans-grants/see-what-sba-offers/sba-loan-programs/general-small-business-loans-7a/7a-loan-program-eligibility

Chart 15: Over $90 billion of 7(a) adjustable rate SBA loan deals have been issued, with about $34 billion outstanding



Source: BofA Global Research, Small Business Association

Chart 16: Loans with terms greater than 10-years comprise the majority of outstanding 7(a) adjustable rate product



Source: BofA Global Research, Bloomberg

Under the 7(a) program, loans for working capital are allowed a maximum term of 7-10 years, while those for real estate and equipment may have a maximum term of 25 years. The maximum maturity of loans used to finance fixed assets other than real estate will have a term equal to the economic life of those assets, but cannot exceed 25 years.

Interest rates

Interest rates are negotiated with the lender, may be fixed- or adjustable-rate, and vary depending on the size and maturity of the loan. **In practice, the vast majority of outstanding 7(a) loans (roughly 98%) have adjustable rates.** All loans, however, whether fixed- or adjustable-rate, are quoted as a base rate plus a spread. The base rate is defined as the lowest prime rate, LIBOR or an optional peg rate that is a weighted average of rates that the government pays for loans with maturities similar to the average SBA loan.

With adjustable rate loans, the lender and borrower negotiate the amount of spread, which will be added to the base rate, as well as an adjustment period that defines the frequency at which the note rate can change. It must adjust on a consistent pre-defined schedule not more often than monthly. Current coupons for approximately par-priced, adjustable rate 7(a) pools are roughly the prime rate *minus* 265bp, where the -265bp represents the spread that was negotiated between the lender and the borrower. With fixed-rate loans, interest rates vary between the base rate plus 2.25% and 4.75% (Table 4), depending on loan size.

Table 4: Coupon calculation for fixed-rate 7(a) SBA loans

	Base rate plus (in bp) for loan tenors:	
Loan Size	Less than 7 years	7 years or greater
$25k or less	425	475
Between $25k and $50k	325	375
Greater than $50k	225	275

Source: Small Business Administration

Pooling guidelines

If a pool assembler chooses to bundle loan guarantees into a standard SBA pool, which is structured as a single-tranche pass through, the following criteria must be adhered to:

- There must be no fewer than four individual loans per pool,
- No individual loan may exceed 25% of the total pool balance,
- The minimum pool size must be $1 million,

- For pools issued after September 30, 2019, the maturity date of the shortest loan currently must be at least 94% of the maturity of the longest loan in the pool.

- The minimum number of loans in WAC pool is 10, with no one loan exceeding 10% of the total pool balance,

- The minimum pool certificate size is $25,000 with multiples in excess of the minimum certificate denomination of $5,000,

- The maximum coupon difference (note rate to the borrower) between the loan with the highest and lowest coupon in a given pool is 2%. On WAC pools specifically the difference can be no greater than 75bp.

- Standard pool coupons reset every 90 days, WAC pool coupons reset monthly based upon the remaining loans in the pool.

Investors can obtain a list of all SBA 7(a) pools issued by typing SBA <MTGE> go on their Bloomberg terminal. Each pool, its cusip, issue date and original balance is listed on the ensuing screen, which an investor can then use to perform further due diligence.

While SBA 7(a) deals may share certain similarities with traditional CMBS, a few important structural differences exist. In SBA 7(a) deals:

- Principal is paid according to an amortization schedule that is based on the maturity date of the longest individual loan in a given pool. So, although a loan within a pool may be scheduled to mature before the pool's maturity date and therefore should amortize more quickly, the payments to investors are still calculated based on the tenor of the pool. For example, if a pool contains four loans, three with 10-year maturities and the other with an 8-year maturity, they all amortize to a 10-year schedule. If the loans with 10-year maturities prepay, the 8-year loan would still amortize on a 10-year schedule until it matured.

- The difference between the principal received and that which is passed through to investors is held by Colson, the SBA's fiscal and transfer agent, in the Master Reserve Fund (MRF) to ensure timely payment of principal and interest. According to the Federal Register as of September 21, 2004, "SBA established the Master Reserve Fund (MRF), which has served as a self-funding mechanism to cover the cost of the timely payment guarantee. Borrower payments on the guaranteed portion of pooled SBA 7(a) loans, as well as any SBA guarantee payments on defaulted SBA 7(a) loans, are deposited into the MRF and all payments to investors (Registered Holders) are made from the MRF. Interest earned while the payments are in the MRF is used, as needed, to make the timely payments to the Registered Holders. Fixed-rate pools have a 70-day delay, while floating rate pools have an 85-day delay. In its 35 year existence, there have always been sufficient funds in the MRF to meet SBA's timely payment obligations."

Prepayment analysis and relative value

Loans made as part of the 7(a) program carry a penalty (that is retained by the SBA) that a borrower must pay if he voluntarily prepays his loan when:

- the maturity is 15 years or more; and

- the prepayment amount exceeds 25 percent of the outstanding balance of the loan; and

- the prepayment is made within the first three years after the date of the first disbursement (not approval) of the loan proceeds.

If the prepayment is made during the first year after funds are disbursed, the borrower must pay a penalty equal to 5 percent of the prepayment amount. If the prepayment occurs during the second or third years following the disbursement the borrower must pay 3% or 1%, respectively, of the prepaid amount.

Guarantee and servicing fees

A one-time guarantee fee and monthly servicing fees are charged for each loan[3]. A guaranty fee on all loans up to 12 months in maturity is 25bp and must be submitted by the borrower with the application. For loans with tenors greater than 12 months, the lender pays the guarantee fee, but may pass it on to the borrower following the first disbursement. According to the SBA, the following fee structure applies for loans approved after December 8, 2004:

- Loans with a maturity of 12 months or less are charged a 25bp guarantee fee.
- For loans of $150,000 or less, a 2 percent guarantee fee is charged.
- For loans more than $150,000 but up to and including $700,000, a 300bp guarantee fee will be charged.
- For loans greater than $700,000, a 350bp guarantee fee will be charged.
- For loans greater than $1,000,000, an additional 25bp guarantee fee will be charged for that portion greater than $1,000,000. The portion of $1,000,000 or less would be charged a 350bp guarantee fee; the portion greater than $1,000,000 would be charged at 375bp.

The annual on-going servicing fee for all 7(a) loans approved on or after October 1, 2007, was 55bp of the outstanding balance of the guaranteed portion of the loan and remained in effect for the term of the loan. This is not a fee that may be passed to the borrower and is deducted from the rate a secondary market investor receives. Note that the American Recovery and Reinvestment Act, which was signed into law in February 2009, authorized a temporary elimination of the borrower upfront guarantee fee on 7(a) loans with tenors longer than 12 months, through the end of calendar year 2009, or until funds appropriated for this provision were exhausted. The end date was subsequently changed to terminate in September 2012.

[3] Whereas the lender may charge the guarantee fee to the borrower upfront, its annual service fee to the SBA may not be charged to the borrower.

SBIC Debenture Program

The Small Business Investment Company (SBIC) Program was created in 1958 to supply equity capital, long-term loans and management assistance to qualifying small businesses. The structure of the program can be thought of as a public-private partnership in which privately-owned and managed investment funds (SBICs) that are licensed and regulated by SBA use their own capital *plus* funds borrowed with an SBA guarantee to make equity and debt investments in qualifying small businesses. In essence, the SBA's role can be thought of as operating a fund of funds, and due to the unique public-private partnership at the core of the program, no annual appropriations are required from Congress to fund SBICs. SBIC debentures are periodically pooled and sold to investors as SBA Guaranteed certificates.

Criteria for small business borrowers and SBIC investors

Hurdles exist for small businesses that need financing as well as for the SBICs that want to raise money to invest in these businesses. To qualify as a small business under this program, a company's net worth must be $18 million or less and its average after tax net income for the prior two years can't exceed $6 million. Additionally, SBICs must invest at least 25% of their capital in smaller businesses, which are those with a tangible net worth of less than $6 million and an average net income of $2 million over the previous two years as of the time of investment. All of a company's related entities, including subsidiaries, parent companies and affiliates, are considered when determining the size standard.

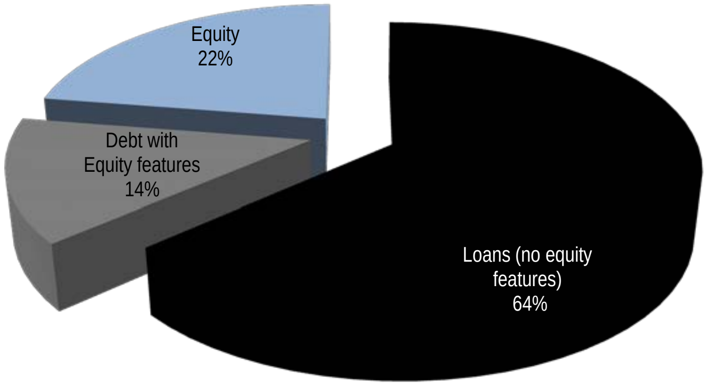
To qualify as an SBIC, the SBA requires a management team to have significant experience in the investment area in which it is proposing to invest. This should be evidenced by a track record of superior returns benchmarked against funds of the same vintage and style, senior-level decision making experience in a private equity or mezzanine fund similar to the proposed fund, a deep, seasoned management team with hands-on experience and existing private capital that is comprised of diverse private limited partnerships. In addition to what an SBIC must do, it may not:

- Invest more than 30% of its private capital in any single portfolio company,
- Invest in businesses with more than 49% of employees located outside of the U.S.,
- Control small businesses for more than seven years without prior approval from the SBA, and
- Invest in companies or sectors that are "deemed contrary to the public interest," or in project finance, real estate or financial intermediaries.

As the first step in becoming an SBIC, a fund first raises money from private investors that can include pension funds, insurance companies, or banks to name a few. After private investment capital is raised and committed, the SBA issues a commitment letter that reserves federal guarantee funds for up to five fiscal years. The SBA will not provide more than three times the private capital raised, although typically most funds are limited to leverage no greater than two times the amount of private capital that is raised. For example, if an SBIC raises $5 million from investors the SBA will commit up to $10 or $15 million, bringing the total fund size to $15-$20 million.

As an SBIC requests a "draw" for funding from the SBA, a debenture is executed in conjunction with each draw. This debenture is held by an agent of the bank that provides the initial interim financing until a critical mass of debentures exist, which are then pooled and issued. The capital provided by SBA has a 10-year maturity and semi-annual interest payments. As a result of the structure of this financing, most SBICs focus primarily on providing small businesses with debt or debt with equity features. According to current information on the SBA's website, roughly $5.5 billion in debenture SBIC financings were made to small businesses in FY 2019 as follows (Chart 17).

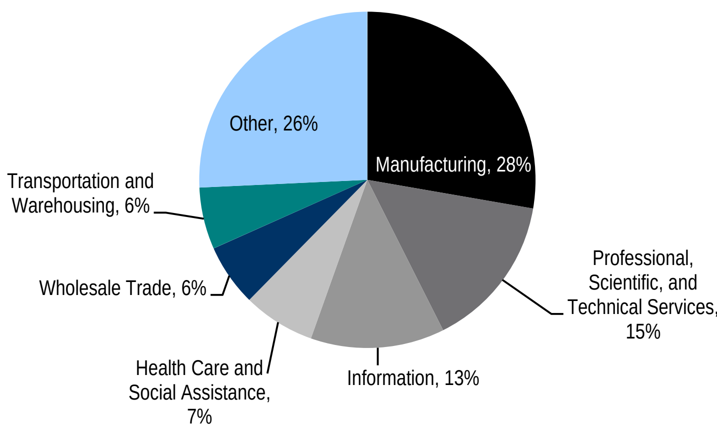
Chart 17: Distribution of debenture SBIC financings as of 9/30/2019



Source: SBA

As a result, SBICs will typically focus on companies that are mature enough to make interest payments on the investment so that, in turn, the SBIC can meet its interest obligations to the SBA. Compared to the traditional venture capital industry, which largely focuses on technology-related companies in the northeast or northwest, SBICs have historically invested across a broader array of businesses (Chart 18).

Chart 18: Industry type distribution of debenture SBIC financings reported FY 2010-2014

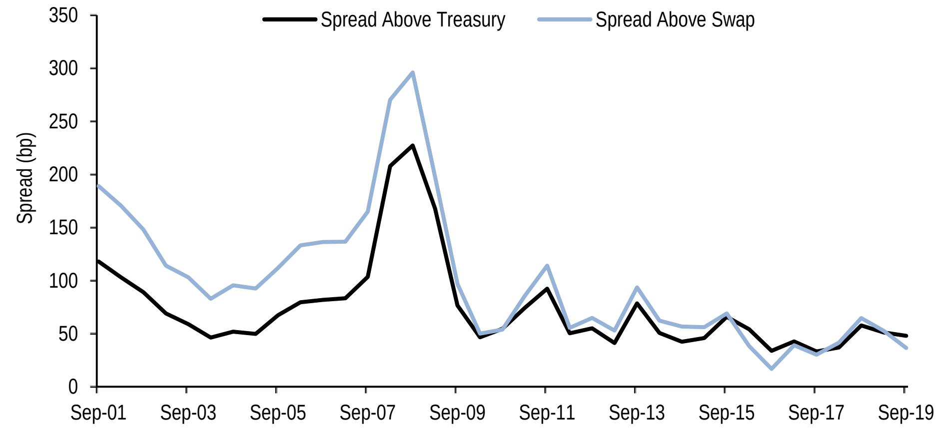


Source: BofA Global Research, SBA

As mentioned above, interim financing is provided prior to pooling by an agent bank, which is the Federal Home Loan Bank of Chicago. Every six months, the bank aggregates the SBIC debentures it holds, pools them and sells them to a Trust. The Trust issues certificates collateralized by the debentures, which it then sells to investors. Prior to issuing certificates, however, as the pooling occurs, the SBA signs an agreement with the Trust to guarantee all interest and principal payments due on the debentures in the pool. **Investors can find SBIC transactions on Bloomberg by typing SBIC <MTGE> go. Deal monikers include the year in which it was issued, a hyphen, and a suffix of either P10A or B, with the letter corresponding to whether the deal was issued in the spring (A) or the fall (B). For example, SBIC 2019-10A represents an SBIC transaction that was issued in the spring of 2019.**

Before certificates are sold to end investors, the price (and spread) is determined by the then-current yield on the 10-year Treasury note plus a market spread that accounts for liquidity and prepayment risk (Chart 19). Market convention is to price transactions to a 7% CPR.

Chart 19: Spread to 10-year Treasury and swap yield for debenture pricing since 2001



Source: Bloomberg

Over the past 12 years the debenture spread to the 10-year Treasury note has varied between a wide of 218bp in March 2008 to a tight of 33bp in September 2017. The spread on the most recent debenture was 48bp. Similar to guaranteed tranches from Freddie Mac or Fannie Mae multifamily transactions, SBIC debentures are structured as pure pass throughs and offer no time tranching

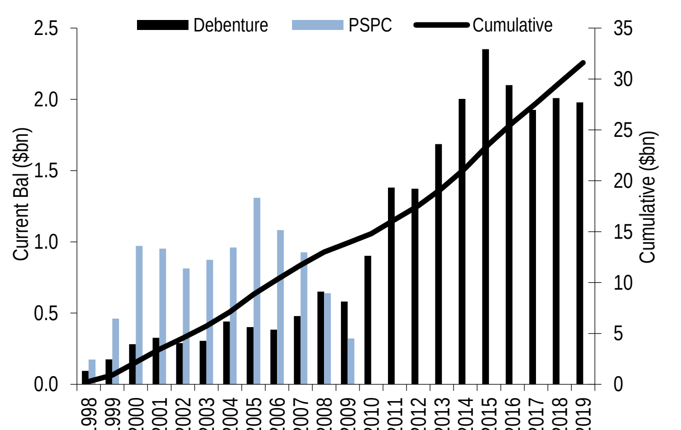
How the SBA funds its guarantee for the SBIC program

Similar to the G-fee charged by Freddie Mac for its K-series program, SBICs pay certain fees to the SBA, which it uses to fund future guarantee payments. SBICs pay a leverage fee that is equal to 3% of SBA's capital commitment. One percent is paid when the SBIC obtains an SBA commitment, while the remainder is paid by the SBIC when the money is drawn against the commitment. In addition, SBICs also pay additional fees totaling approximately 35bp of the amount drawn to help offset the cost of selling the debentures and Trust Certificates.

Issuance

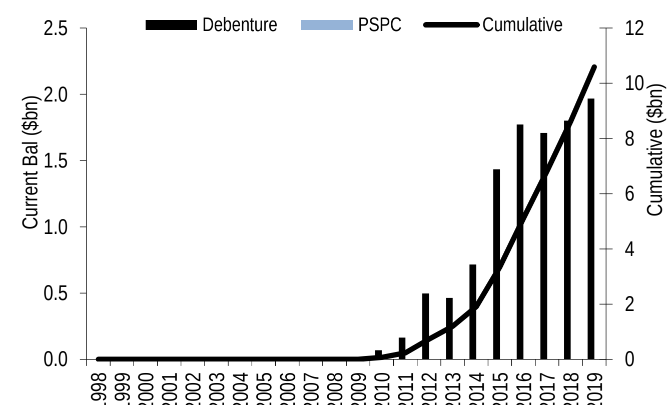
Deals are issued semi-annually, and since 1998 approximately $22.1 billion of debentures and $9.5 billion of PSPCs (Participating Securities) have been issued (Chart 20).

Chart 20: SBIC debenture issuance has increased significantly over the past few years



Source: BofA Global Research, SBA

Chart 21: The amount of PSPCs outstanding has fallen to 0 as a result of the phase-out of the program in 2009 while debenture volume grew significantly since 2009



Source: BofA Global Research, SBA

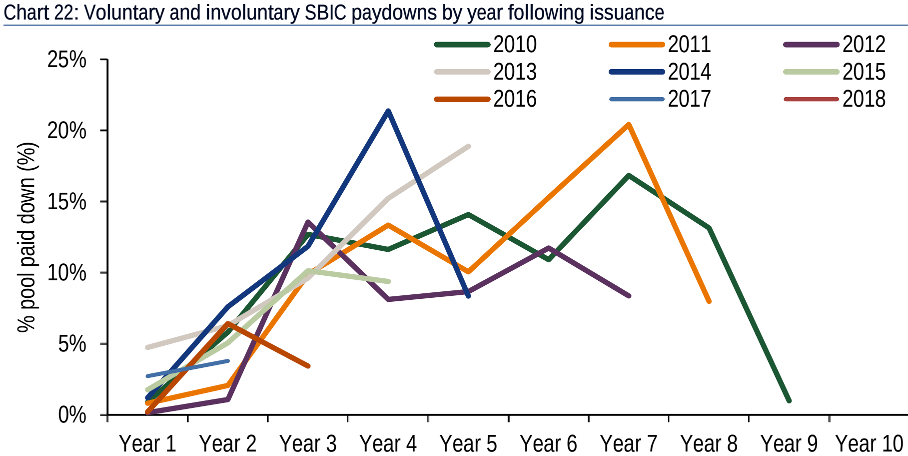
In 2009, however, the PSPC program was phased out and as a result, outstanding PSPC volume fell dramatically while debenture volume grew commensurately (Chart 21).

Prepayments and defaults

Since the program's inception in 1986, rules regarding an SBIC's ability to prepay its loan have continually evolved. Between the 1986 and March 25, 1992, an SBIC was unable to prepay its loan during the first five years of the term, but could do so during the second five subject to paying a 5% prepayment penalty that declined by 1% annually until maturity. In 1992, the initial five-year lockout was removed, and between June 24, 1992 and September 12, 2006 an SBIC could prepay its loan at any time, however, it was still subject to the declining premium prepayment penalty. **Finally, beginning on September 13, 2006, all subsequent pooled debenture deals were issued with no prepayment penalties, which allowed an SBIC the right to prepay any of the debentures it issued on any semi-annual payment date without penalty, provided the debenture is prepaid in full.**

In the event of a default by an SBIC, the principal amount of its debenture in a Pool will be immediately due and payable. When this occurs, SBA will make a payment pursuant to its Guarantee of 100% of the principal amount of the debenture together with accrued interest to the next payment date. If we consider the rate of historical voluntary and involuntary prepayments for the 2007 through 2016 cohorts (which is the most recent data we were able to obtain), we see that on average, the amount of a pool paying down increased into the fourth year and then tailed off (Chart 22).

Chart 22: Voluntary and involuntary SBIC paydowns by year following issuance



Source: BofA Global Research, SBA

Interestingly, for the 2008 cohorts, pay downs during the second year were higher than was seen among earlier cohorts. We believe this may be due to involuntary payments (defaults) that resulted from the high unemployment and economically stressful environment, in which some of the SBICs' investments didn't survive.

Conclusion

The guarantee of the full faith and credit of the U.S. government allows investors with limited commercial real estate or CMBS knowledge to diversify their portfolios without the inconvenience of a steep learning curve. SBA guaranteed loans or pools have regular issuance schedules, trade with good liquidity in the secondary market and offer investors an attractive alternative to residential MBS CMOs or Agency CMBS.

Not only are all investors guaranteed timely payment of principal and interest by the full faith and credit of the U.S. government, bank investors can enjoy zero-percent risk weighting on pools and either zero- or 20-percent risk weighting on loans (depending on the bank's regulatory authority) . Furthermore, some investors may be able to buy these securities as a means to satisfy Community Reinvestment Act (CRA) requirements.

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