A Primer On SBA Lending Programs, With An Emphasis On the Role of Life Insurance in SBA Lending

A White Paper

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I. A General Overview of the SBA, Its Lending Programs, and the Types of SBA Lenders

The United States Small Business Administration, or "SBA", is the administrative agency of the federal government that is charged with the mission of fostering the growth of small businesses. The SBA offers its support through a number of different loan programs, most of which do not involve direct loans made by the government but instead involve the issuance of loan guarantees.

In the SBA's loan guarantee programs, the SBA sets guidelines for the types of loans that its lending partners can make to small businesses that will qualify for a loan guarantee from the SBA. These lending partners include banks, non-bank lenders, and community development organizations. The loan guarantees are usually conditional and contingent upon the loans meeting all of the SBA's regulatory criteria for the origination, documentation, closing, servicing and liquidation of the loans. If the lending partner meets the criteria, the SBA guarantees that an agreed-upon portion of the loan will be repaid. That partial guarantee reduces the risk to the lending partner, which may then make a loan to a small business borrower who would not qualify for a conventional commercial loan.

Thus, when a small business applies for an SBA loan, it is actually applying to an SBA lending partner for a commercial loan that will meet the SBA's requirements for the lender to obtain an SBA guarantee. Because the SBA guarantee is so valuable, lending partners who originate, service and liquidate SBA loans are very concerned with complying with the SBA's regulatory requirements. Those requirements are amended frequently, so lending actions that were satisfactory to the SBA in the past may no longer be acceptable to the SBA in similar transactions in the future. It is therefore important for those involved in SBA lending to confirm that their proposed actions are in compliance with the most recently issued rules and regulations for the SBA's lending programs.

A. *The SBA's Lending Programs*

1. The 7(a) Loan Program.

The SBA's primary lending program, and the lending program that most lenders and borrowers have in mind when they think about SBA lending, is the SBA's 7(a) Loan Program. The 7(a) Loan Program provides financing for a variety of general business purposes to both start-up entities and existing small businesses. It is delivered to borrowers through lending partners in the form of loan guarantees.

The 7(a) Loan Program is a deferred loan participation program; in other words, the SBA does not become actively involved in the loan until it defaults, and the SBA's guarantee is conditional on the loan meeting all of the SBA's program requirements.

Under the 7(a) loan program, the SBA guarantees 50% to 85% of the lender's loan amount. The size of the loan can be up to $5,000,000.00, with a maximum guarantee limit of $3,750,000.00. The SBA loan can be made to one or more borrowers, and the proceeds of the

loan can be used for many purposes, including the purchase of real estate and/or equipment, business acquisition, working capital, or refinancing of prior debt. The maturity of the loan can be from 1 to 25 years, depending upon the purpose of the loan and the collateral involved, and the interest rate on the loan can be fixed or variable (within certain limitations). The borrower is qualified based upon the ability of its cash flow to service the debt of the SBA loan rather than the ability of the borrower to provide sufficient capital to repay the loan in the event of default. As a result, many SBA loans made under the 7(a) loan program have a collateral shortfall.

In 7(a) loans, the borrower must be a for-profit business that meets the SBA's requirements for being considered a "small" business. In addition, applicants for 7(a) loans must demonstrate a need for having a guarantee on the loan by showing that they are unable to obtain financing on "reasonable terms" in the (conventional) lending marketplace (SBA's "credit elsewhere" test). There are also limitations on the types of individuals and entities that can own the small business concern, as well as the types of businesses that can qualify for SBA lending. Most notably for the purposes of this White Paper, 7(a) loans cannot be made to businesses engaged in selling life insurance, businesses engaged in lending, or passive businesses (such as being a landlord).

Lenders who participate in the 7(a) loan program often sell the guaranteed portion of their loan (that, is the 50% to 85% that is guaranteed by the SBA) into a secondary market populated by investors that are looking to purchase the guaranteed payments. The secondary market investors pay the lending partner up front for their interest in the closed SBA loan, and the lending partner books the revenue on the loan at that time. That revenue, however, is subject to a contingent liability back to the SBA, which is described in greater detail below.

In the event that the loan defaults and goes into liquidation, the SBA is required to honor its guarantee to the secondary market investor by paying it the balance due on the guaranteed portion of the SBA loan. The SBA will then notify the lending partner that it either has to: (1) repay the secondary market investor with its own funds, or (2) direct the SBA to repay the secondary market investor with the SBA's funds. If the lending partner pays the secondary market investor itself, it may make an application to the SBA to honor its guarantee on the loan by purchasing the guaranteed portion of the loan from the lending partner and paying the guaranteed funds back to the lender. If the lending partner directs the SBA to repay the secondary market investor with the SBA's own funds (*i.e.,* repurchase the guaranteed portion of the loan back from the secondary market), the SBA will direct the lending partner to make a prompt submission to the SBA in order for the Agency to determine whether the Government should honor its guaranty by purchasing the guaranteed portion of the loan from the lending partner. If the SBA purchases the loan, the lending partner will not owe any money back to the SBA for the cost of paying off the secondary market investor. If the SBA refuses to purchase the loan (or reduces the amount of the loan that it will purchase) for regulatory compliance reasons, the lending partner will have to repay the SBA for the cost of repaying the secondary market investor.

Lending partners participate in the 7(a) lending program for several reasons. First, doing so allows them to make loans that they would otherwise be unable to make as conventional business loans. For example, many SBA borrowers cannot provide sufficient collateral for their

loans and are therefore unable to secure loans from conventional lenders. Second, the ability of the lending partners to sell the guaranteed portions of the 7(a) loans into the secondary market provides them with an opportunity to realize significant revenue promptly after closing the loans. Third, lenders are able to offer significantly longer terms through the 7(a) program than through their conventional products, which provide small businesses with enhanced cash flows.

2. The 504 Lending Program

The 504 program (also sometimes referred to as the CDC program) provides long-term, fixed-rate financing to acquire fixed assets (such as real estate or long term durable equipment like printing presses) for business expansion, business acquisition, modernization, or, in limited circumstances, refinancing. It is designed for small businesses requiring "brick and mortar" financing, and it is delivered by Certified Development Companies ("CDCs")—private, non-profit corporations set up to contribute to the economic development of their communities.

Unlike the 7(a) Loan Program, the 504 Loan Program is an immediate participation loan program; that is, the SBA actively participates in the loan from its inception. In a 504 Loan, a private lender provides up to 50% of a project's cost and obtains a senior lien. The CDC extends a second loan up to a maximum of 40% of the project cost, and obtains a junior lien position on the pledged collateral. The SBA unconditionally guarantees the CDC's loan, and the borrower contributes the remaining 10% (or more, depending upon the circumstances) of the project's cost. Unlike SBA loans made through the 7(a) Loan Program, loans made through the SBA's 504 Loan Program are typically fully secured by the loan collateral.

Under the 504 Loan Program, the CDC prepares the loan documents and then assigns them to the SBA. The interest rate on notes for 504 loans is fixed, with a maturity of either 10 or 20 years, depending upon the collateral and purpose of the loan. Unlike 7(a) loans, the borrower's capital contribution to the project may be borrowed in some circumstances.

Lenders participate in the 504 Loan Program because it allows them to obtain a first lien on collateral with limited risk exposure. A lender on a $1,000,000 project, for example, could make a $500,000 loan secured by a first position lien on real estate worth the full $1 million.

As in 7(a) loans, the borrower on a 504 SBA loan must be a for-profit business that meets the SBA's requirements for being considered a "small" business. In addition, applicants for 504 loans must similarly demonstrate a need for having an SBA guarantee involved in their loan by showing that they are unable to obtain credit elsewhere on reasonable terms in the (conventional) lending marketplace. There are also limitations on the types of individuals and businesses that can own the borrower, as well as the types of businesses that can qualify for SBA lending.

3. The SBA's Other Loan Programs

The SBA has a variety of other Loan Programs in addition to its flagship 7(a) and 504 Loan Programs.

The SBA Express Loan Program allows SBA lending partners to approve loans up to $350,000 with a guarantee limit of 50%. The Express Loan program allows lenders to use their own commercial loan documents, but sets limits on the interest rates that lenders can charge based on the size of the loan. Similar to SBA Express, 7(a) Small Loan and Community Advantage often target small business loans made to veterans and individuals in underserved communities.

The SBA also provides several loan programs specifically designed to help develop or expand export activities. These include Export Express, Export Working Capital, and International Trade loans.

The CAP Lines Program provides loans up to $5 million, and is designed to help small businesses meet their short-term and cyclical working capital needs. The programs can be used to finance seasonal working capital needs; finance the direct costs of performing certain construction, service and supply contracts, subcontracts, or purchase orders; finance the direct cost associated with commercial and residential construction; or provide general working capital lines of credit that have specific requirements for repayment. There are four distinct loan programs under the CAP Lines umbrella: (1) the Contract Loan Program; (2) the Seasonal Line of Credit Program; (3) the Builders Line Program; and (4) the Working Capital Line of Credit Program.

The Microloan Program provides small short-term loans up to $50,000 for working capital or the purchase of inventory, supplies, furniture, fixtures, machinery and/or equipment. It is designed for small businesses and not-for-profit child-care centers needing small-scale financing and technical assistance for start-up or expansion, and is delivered through specially designated intermediary lenders, usually nonprofit organizations with experience in lending and technical assistance.

The Disaster Assistance Loan Program provides low-interest loans to homeowners, renters, businesses of all sizes and most private non-profit organizations to repair or replace real estate, personal property, machinery and equipment, inventory and business assets that have been damaged or destroyed in a declared disaster.

B. *The Types of SBA Lenders And Their Delegated Authority From The SBA*

The SBA permits certain lending authority to be delegated to lenders who have experience making SBA loans. The types of SBA lenders can generally be categorized into three groups based upon their level of delegated authority from the SBA.

The first level of lenders are General Processing (or "GP") lenders. GP lenders are the least experienced lenders and receive next to no delegated authority from the SBA. Lenders who are GP lenders do not have the authority to approve SBA loans for themselves; instead, they must submit applications for SBA loans to the SBA for approval. If the loan is approved, the SBA prepares the Loan Authorization that sets the terms for the SBA loan. Once the Loan Authorization is issued, GP lenders are not permitted to modify the terms of the loan without the SBA's express prior written consent.

The intermediate level of lenders are Certified Lenders Program ("CLP") lenders. CLP lenders are more experienced and therefore have greater delegated authority from the SBA. This allows for streamlined applications to the SBA, but still requires the SBA's consent for many actions.

Preferred Lenders Program ("PLP") lenders are the most experienced lenders, and they have the highest level of delegated authority from the SBA. Their application process is the most efficient, as PLP lenders are allowed to prepare their own Loan Authorizations setting the terms for their own SBA loans. They are also allowed to revise Loan Authorizations without the SBA's express prior consent. The high level of authority provided to PLP lenders comes with great responsibility, however, as the SBA holds PLP lenders accountable for adhering to all of the regulatory requirements of the SBA lending programs. As a result, the SBA often second-guesses PLP lenders' lending decisions at the time of guarantee purchase, especially on high dollar early defaulting facilities.

C. *The Regulation of SBA Lenders*

The SBA's lending programs are governed by regulations contained in the Code of Federal Regulations ("C.F.R.") at 13 C.F.R. Chapter I, 13 C.F.R. § 101.100, *et seq.*

The regulations set forth in the C.F.R. are implemented by the SBA through a series of lengthy and detailed Standard Operating Procedures ("SOP"), which are codified by the SBA and available on its website, www.sba.gov.

The most recent SOP for the origination of SBA loans and the different types of SBA lenders is SBA SOP 50 10 5(H), which took effect on May 1, 2015 and is available online at http://www.sba.gov/content/clean-final-50-10-h. SOP 50 10 5(H) replaces SOP 50 10 5(F), which took effect on January 1, 2014.

II. The Role Of Life Insurance In SBA Lending

Life Insurance plays a much more significant role in SBA loans made through the 7(a) Loan Program than it does in SBA loans made through the 504 Loan Program. As noted above, 7(a) loans are often under-secured—that is, the loan is made even though the borrower does not have sufficient collateral to pay off the loan in the event that it enters into default and the collateral is liquidated. This under-collateralization presents a risk of loss to the SBA lender if the borrower's business fails due to the death of the principal of the borrower. In contrast, SBA

loans made through the 504 Loan Program are typically fully collateralized; as a result, the risk of loss to the SBA lender in the event of the borrower's business failure due to the death of one of its principals is much less.

In recognition of this situation, **SOP 50 10 5(H) requires that, for 7(a) loans that are over $350,000.00 and are not fully secured, life insurance must be obtained for the principals of sole proprietorships, single member LLCs, or for any other borrowers whose businesses are dependent on one owner's active participation, consistent with the size and term of the loan.** SBA SOP 50 10 5(H), Chapter 5, Section II(D), pp. 185-186.

Thus, in order for a SBA 7(a) lender to make an SBA-guaranteed loan in excess of $350,000 to a borrower where the ***active participation*** of a ***single individual***—whether he or she is the sole proprietor/proprietress, the sole member of the borrower's LLC, or the sole individual qualified to run the business—is critical to the viability of the borrower's business, the lender ***must*** ensure that the borrower has secured life insurance for the benefit of the lender.

In contrast, if the borrower's business is ***not*** dependent upon the active participation of a single individual, such as where there are multiple principals who are individually capable of operating the business, the SBA only requires that the lender comply with its own internal requirements regarding life insurance for similarly sized conventional loans. Those internal requirements obviously vary from SBA lender to SBA lender; some of them require life insurance, while others may not.

Similarly, for loans processed under SBA Express, Export Express and 7(a) Small Loan, lenders are required to follow their own internal policies for obtaining life insurance with regard to similarly sized non-SBA guaranteed commercial loans. SBA SOP 50 10 5(H), Chapter 5, Section II(D), p. 186.

The determination of the appropriate amount of life insurance needed for a particular SBA loan may take into account the amount and type of collateral available to repay the loan. Thus, if the collateral shortfall for a particular SBA loan is modest, the lender may consider securing life insurance in an amount that is less than the principal balance of the loan.

If, during the process of attempting to secure life insurance for a borrower on an SBA loan, the lender determines that the principal of the borrower is uninsurable, the lender must obtain written documentation from a licensed insurer.

The rules for requiring life insurance for SBA loans made through the 504 Loan Program are similar. A CDC making a 504 loan must determine if the viability of the borrower's business is tied to a particular individual or individuals. In those situations, the CDC must require life insurance on the lives of those individuals in order to make the loan. SBA SOP 50 10 5(H), Chapter 5, Section I(D)(4), p. 300. As with Section 7(a) loans, the life insurance required must be consistent with the size and term of the loan, and the amount and type of collateral available to repay the loan in the event of the death of the borrower should be factored into the determination of the appropriate amount of life insurance. Please note, however, that because

lenders in the 504 program almost always fund appraised real estate and secure a first lien, the need for life insurance occurs less often as the lender is often sufficiently protected.

For all life insurance policies obtained for SBA loans, the lender or CDC must obtain a collateral assignment, identifying the lender/SBA or CDC/SBA as the assignee. The collateral assignment must be acknowledged by the Home Office of the Insurer, and the lender or CDC is responsible for assuring that the borrower pays the premiums on the policy. SBA SOP 50 10 5(H), Chapter 5, Section I(D)(4), p. 300. SBA lenders should be aware that an increasing number of insurers refuse to provide an acknowledged collateral assignment. Instead, they furnish letters stating that a collateral assignment is in place. Such letters do not meet SBA program requirements.

When an SBA Lender receives notice that the required payments on a life insurance policy required by the loan documents have not been made, the decision whether or not to continue coverage on that policy should be based on prudent lending practices and made on a case-by-case basis. SBA SOP 50 57 2, Chapter 9, Section D(3), p. 63; SBA SOP 50 55, Chapter 9, Section D(3), p. 69. For example, the lender should determine whether the balance due on the SBA loan exceeds the recoverable value of the collateral for the loan, taking into account any senior liens in favor of taxing authorities and other creditors. If the balance on the loan has been paid down to the point at which the SBA has become fully secured by the existing collateral, continuing the life insurance may not be necessary (in such cases, the lender may need to obtain a more recent appraisal to justify and document its decision). If the lender does elect to continue the life insurance coverage by paying the premium, that cost can and should be treated as a Recoverable Expense—that is, an expense that is partially reimbursable by the SBA as a servicing cost on the SBA loan. SBA SOP 50 57 2, Chapter 9, Section D(3), p. 63; SBA SOP 50 55, Chapter 9, Section D(3), p. 69. Life insurers and their agents can often assist SBA lenders in identifying, preempting and addressing these problems by providing the lenders with duplicate premium bills, billing reminder notices, and notices of nonpayment.

A CDC making a 504 loan may accept the pledge of an existing life insurance policy to satisfy its life insurance requirement. When a new policy is required, a decreasing term policy may be used. Although a borrower may not be required to obtain a cash value life insurance policy as a condition for obtaining the SBA financing,, a borrower may elect to purchase a cash value life insurance policy for that purpose. *See* SBA SOP 50 10 5(H), Chapter 5, Section I(D)(4), p. 300.

In order to ensure that the borrower pays the premiums on a life insurance policy with a collateral assignment for the benefit of the lender (and the SBA) for a 7(a) loan, an escrow account may be set up by the lender to collect the funds needed to pay the premiums on the life insurance policy. SBA SOP 50 57 2, Chapter 9, Section D(2), p. 63. Deciding whether to establish such an escrow is left to the discretion of the lender or CDC.

III. Servicing Issues With Life Insurance Policies In SBA Lending

Over the course of the term of an SBA loan, it occasionally becomes necessary for a lending partner of the SBA to revisit the life insurance policy obtained at the loan's origination.

The life insurance requirements in the original loan documents should not be modified or terminated by the lender unless the reason for requiring the life insurance policy no longer exists. SBA SOP 50 57 2, Chapter 9, Section D(1), p. 62; SBA SOP 50 55, Chapter 9, Section D(1), p. 68. For example, life insurance might no longer be necessary (or be required in the same amount) if the business no longer becomes dependent upon the active participation of the individual at issue, or the principal amount of the loan is sufficiently reduced so that the SBA loan is no longer under-secured.

As noted in Section II above, if the Lender receives notice that the required premium payments for a required life insurance policy have not been made, the lender's decision whether or not to continue coverage should be based on prudent lending practices and made on a case-by-case basis. If coverage is continued by the lender, the cost can and should be treated as a Recoverable Expense—that is, an expense that is partially reimbursable by the SBA as a servicing cost on the SBA loan. SBA SOP 50 57 2, Chapter 9, Section D(3), p. 63; SBA SOP 50 55, Chapter 9, Section D(3), p. 69. Again, this is an area where the SBA provides the lending partner with broad discretion to apply prudent lending standards.

The SBA generally requires that the proceeds from an assignment of a life insurance policy be applied to the principal balance of the loan without advancing the payment due date. That is, the proceeds of the policy, if they are greater than the amount due for the currently due payment on the authorized repayment schedule, are credited to the final installments of the principal, thereby reducing the maturity of the loan but not affecting the original repayment schedule.

In addition, depending on the circumstances, all or part of the proceeds of a life insurance policy for a 7(a) loan may be released to the borrower if, in addition to meeting certain regulatory requirements for the release of loan collateral, the lender determines that death of the insured will have no significant impact on the management of the small business borrower and:

(1) The proceeds are needed for a valid business purpose;

(2) The proceeds are needed to prevent Financial Hardship (as that term is defined in SBA SOP 50 57 2 and SBA SOP 50 55); or

(3) Based on the strength of the business, there is no reason to anticipate that the loan will not be repaid in full. SBA SOP 50 57 2, Chapter 9, Section D(4), p. 63; SBA SOP 50 55, Chapter 9, Section D(4)(b), p. 69.

Alternatively, if the estimated resilience of the business is not strong enough to justify the release of the life insurance proceeds or weak enough to justify immediate application to the loan balance, the life insurance proceeds may be placed in an escrow account for distribution at a later date after the lender has had the opportunity to observe the Borrower's on-going operations and

is able to make a prudent decision. SBA SOP 50 57 2, Chapter 9, Section D(4)(c), p. 63; SBA SOP 50 55, Chapter 9, Section D(4)(c), p. 69.

IV. The Benefits To SBA Lenders Of Partnering With Life Insurers

As discussed above, SBA lenders often require life insurance policies as collateral for their loans in order to both comply with the SBA's regulatory requirements and engage in prudent lending. Moreover, because SBA lenders often encounter servicing issues related to the life insurance placed, it is considered a best practice for SBA lenders to maintain an effective and stable business relationship with a life insurer that has a strong credit rating, offers a diverse portfolio of life insurance products, furnishes acknowledged collateral assignments, and enjoys a long history of meeting the needs of its policyholders. In addition, SBA lenders would be wise to consider partnering with a life insurer who is familiar with the SBA's regulatory and collateral requirements and can expedite its underwriting process in order to meet the prompt deadlines that SBA lenders and their borrowers often require.