Small Business Administration Lending: Risk Management Principles

This attachment to Office of the Comptroller of the Currency's (OCC) Bulletin 2021-34 informs banks[1] and examiners about risks associated with engaging in U.S. Small Business Administration (SBA) lending and provides sound risk management principles.

Banks involved in SBA lending should engage in safe and sound banking practices. Safe and sound banking practices include having a sound risk management system consisting of appropriate policies, processes, personnel, and control systems to identify, measure, monitor, and control the associated risks. Risk management of SBA lending should be commensurate with the nature and extent of a bank's direct and indirect participation in SBA lending programs. The board should have satisfactory knowledge of and engage in sound oversight of SBA lending.

Background

Banks are important lenders for SBA programs. The OCC encourages and supports banks' lending to small businesses, which play a vital part in the economy and the communities they serve. SBA loan programs help banks serve creditworthy small businesses that are otherwise unable to obtain credit at reasonable terms. These small businesses generally have adequate repayment capacity based on reasonable cash flow projections but may have weak collateral or a lack of established credit or cash flow history. The SBA also provides programs that offer technical assistance to help these small businesses survive and prosper.

Banks may receive Community Reinvestment Act credit for certain loans made with SBA guaranties or for participations in other SBA lending programs.[2] The guaranteed portions of SBA loans are afforded certain regulatory relief, such as zero exposure treatment under the legal lending limit regulation (12 CFR 32, "Lending Limits") and either 0 or 20 percent risk weights under the risk-based capital rule (12 CFR 3, "Capital Adequacy Standards").

Key SBA Lending Programs

Banks are most actively involved in two key SBA lending programs:[3]

[1] "Banks" refers collectively to national banks, federal savings associations, and federal branches and agencies of foreign banking organizations.

[2] For more information, refer to 12 CFR 25 (national banks); 12 CFR 195 (federal savings associations); and OCC Bulletin 2020-99, "Community Reinvestment Act: Key Provisions of the June 2020 CRA Rule and Frequently Asked Questions."

[3] SBA Standard Operating Procedure (SOP) 50 10 6, "Lender and Development Company Loan Programs," describes the 7(a) and 504 loan programs' rules, regulations, policies, procedures, and guidance.

- The 7(a) loan program, which guarantees a portion[4] of a loan made by a bank.
- The certified development company (CDC)/504 loan program (commonly referred to as the 504 loan program), which improves a bank's senior secured lender position[5] through subordinated permanent or takeout financing by a CDC.[6]

7(a) Loan Program

Loans made under the 7(a) loan program[7] can be used for the acquisition and carrying of real estate, equipment purchases, working capital, and other eligible purposes. The program provides a default guaranty to reimburse the lender's loss if the lender meets the SBA's underwriting and credit administration requirements. The guaranty covers any remaining unpaid principal and eligible care and preservation of collateral expenses up to the guaranteed amount, after liquidation of the collateral.[8] Loans made under the 7(a) loan program are available to creditworthy businesses, including start-ups, that meet the SBA's "credit not available elsewhere"[9] requirement. Under this requirement, the SBA requires the lender to certify or otherwise show that the desired credit is unavailable to the applicant on reasonable terms and conditions from private, commercial sources without SBA assistance. The SBA requires that lenders take into consideration factors associated with conventional lending practices, including[10]

- the applicant's business industry,
- the operating history of the business,
- available collateral,
- reasonable loan term based on actual or projected business cash flow,

[4] Generally, the maximum guaranty percentage is 85 percent on loans up to and including $150,000 and 75 percent on loans greater than $150,000. During the 2020–2021 COVID-19 pandemic, the SBA was authorized under the Coronavirus Aid, Relief, and Economic Security Act to temporarily provide the Paycheck Protection Program (PPP) pursuant to section 7(a)(36) of the Small Business Act (15 USC 636(a)(36)). The PPP was an extension of the traditional 7(a) loan program and offered 100 percent guaranteed and mostly forgivable loans mainly for payroll purposes during the national emergency. In addition, the SBA temporarily increased the traditional 7(a) loan's guarantee level to 90 percent and waived the SBA's 7(a) guaranty and ongoing servicing fees.

[5] The lender's position is senior to the CDC portion but may be subordinate to other lenders. For more information, refer to 13 CFR 120.920.

[6] For a comparison of the 7(a) and 504 loan programs, refer to table 4, "Comparison of the SBA 504 and 7(a) Loan Programs," in the OCC's *Community Developments Insights* report titled "SBA's Certified Development Company/504 Loan Program: Small Businesses' Window to Wall Street."

[7] For more information, refer to the OCC's *Community Development Insights* report titled "Bankers' Guide to the SBA 7(a) Loan Guaranty Program" and *Community Developments Fact Sheet* titled "What Is the SBA 7(a) Loan Guaranty Program?"

[8] Refer to 13 CFR 120.520(a).

[9] Refer to SBA SOP 50 10 6, part 2, section A, chapter 1.

[10] Refer to 13 CFR 120.101.

- and other factors unique to the applicant that cannot be overcome except through obtaining a federal loan guaranty under prudent lending standards.

504 Loan Program

The 504 loan program provides growing small businesses with long-term, fixed-rate financing for major fixed-asset purchases or improvements.[11] According to SBA regulations, the proceeds of 504 loans may be used for fixed assets, including

- purchase of buildings, land, and land improvements.
- construction of new facilities or modernization, renovation, or conversion of existing facilities.
- purchase of long-term machinery.
- refinance of debt in connection with expansion of a business through new or renovated facilities or equipment.

The financing structure typically involves at least two loans and contributed equity, with the bank providing a secured loan of up to 50 percent of the cost, a CDC providing a debenture-backed subordinate loan of up to 40 percent of the cost, and the borrower contributing between 10 percent and 20 percent equity.[12] In the 504 loan program, the SBA guarantees the CDC loan but not the bank loan. The CDC loan is funded once the debenture is sold in the capital markets.[13] Subject to SBA approval, a bank may make a bridge loan to cover the interim period before CDC funding, with the CDC loan proceeds providing permanent takeout of the bank's bridge loan. For loans secured by real estate, the CDC loan cannot be funded until the occupancy certificate is issued. Therefore, if the project is still in the construction or improvement phase, the bank may provide construction financing.

Originating, Selling, and Purchasing SBA-Guaranteed Loans

Banks can participate in SBA programs by originating SBA-guaranteed loans for their own portfolios. The originating bank can sell a portion of the SBA loan, an entire SBA loan, or an SBA loan portfolio, but certain SBA requirements may apply. Prior SBA approval is required if any sale will result in the originating bank owning a part of the unguaranteed portion of the loan equal to less than 10 percent of the outstanding loan amount.[14] Originating banks that sell only the SBA-guaranteed portion of a loan continue to hold the note and service the loan.

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[11] Refer to 13 CFR 120.882. Also refer to the *Community Developments Insights* report titled "SBA's Certified Development Company/504 Loan Program: Small Businesses' Window to Wall Street" and the *Community Developments Fact Sheet* titled "SBA Certified Development Company/504 Loan Program."

[12] Refer to 13 CFR 120.900. The percentage of financing provided by third-party lenders, a CDC, and a borrower may vary. Refer to 13 CFR 120, subpart H for more information.

[13] Refer to 13 CFR 120.801.

[14] Refer to 13 CFR 120.432.

Banks typically can sell guaranteed portions of SBA loans in the secondary market at a premium to provide fee income and free up liquidity. Banks that sell into the SBA secondary market are required to meet the SBA's reporting and servicing requirements through the SBA's fiscal and transfer agent.[15] Guaranteed portions of SBA loans are sold in the SBA secondary market in two ways:

- Guaranteed Interest Certificates,[16] which represent ownership of the guaranteed portions of the individual loans.
- Guaranteed Loan Pool Certificates,[17] which represent an undivided interest in a pool of SBA-guaranteed portions of loans for which the SBA further guarantees the timely payment of scheduled principal and interest payments.

Under certain circumstances, banks may sell or transfer their entire interest in SBA-guaranteed loans or their entire SBA portfolios to other SBA-approved lenders.[18] Examples include when a bank is acquired by or merges with another bank, leaves an operating area, or ceases its SBA participation. Such sales or transfers are permitted only with the SBA's prior approval.

Banks may sell their unguaranteed portions through securitization, subject to the SBA's prior approval.[19] Certain conditions and requirements apply, including the requirement that a bank retain a minimum amount of the securities' subordinated tranche determined by the bank's "loss rate."[20]

In addition to originating SBA loans, banks can engage in SBA lending by purchasing Guaranteed Interest Certificates, Guaranteed Loan Pool Certificates, and participations in SBA loans.

Conditional Versus Unconditional Guaranty or Takeout Commitment

The SBA guaranty of loans held by the originating bank is considered conditional because the SBA may elect not to honor its guaranty if the bank fails to comply with SBA loan program requirements. The SBA provides unconditional guaranties of SBA loans and securities purchased in the secondary market, including the Guaranteed Interest Certificates and Guaranteed Loan

[15] Refer to 13 CFR 120, subpart F. SBA SOP 50 57 2, "7(a) Loan Servicing and Liquidation," and SOP 50 55, "504 Loan Servicing and Liquidation," cover the SBA requirements and procedures for loan servicing and resolution for the 7(a) and 504 loan programs, respectively.

[16] Refer to 13 CFR 120.600(a). SBA Guaranteed Interest Certificates are reported as loans in the Federal Financial Institutions Examination Council (FFIEC) Consolidated Reports of Condition and Income (call report). Refer to the "Regulatory Reporting" section below for more information.

[17] Refer to 13 CFR 120.600(a) and 120.620. SBA Guaranteed Loan Pool Certificates are reported in the call report as securities. Refer to the "Regulatory Reporting" section below for more information.

[18] Refer to 13 CFR 120.430–120.435.

[19] Refer to 13 CFR 120.420 and 120.425.

[20] Refer to 13 CFR 120.425(b). Loss rate is defined at 13 CFR 120.420(i), "Loss Rate."

Pool Certificates; the SBA reserves the right, however, to claw back from the lender all or a portion of the outlay if the post-purchase review identifies any deficiencies.

The CDC takeout of bank bridge loans or temporary financing in connection with the 504 loan program is considered conditional because of uncertainty around the completion of the CDC takeout. Although a bank can arrange for CDC takeout before completing a real estate construction or improvement project, the CDC may not always execute the takeout arrangement if adverse market conditions significantly affect the project's feasibility and economics.

Risks Associated With SBA Lending

The primary risks associated with SBA lending are credit, operational, compliance, liquidity, price, and strategic, with many of these risks interrelated.

Credit Risk

Borrowers in SBA programs are generally ineligible for conventional bank loans, as they typically lack adequate credit or cash flow history or have weak collateral. Accordingly, the SBA has developed broad underwriting and credit administration requirements to control and mitigate credit risks shared by the SBA and banks. Banks assume credit risk on the guaranteed and unguaranteed portions of SBA loans that they hold. For guaranteed portions, risk is assumed when the guaranty is conditional. For unguaranteed portions, the bank assumes full credit risk.

The SBA requires lenders to analyze each loan application consistent with specific lending standards.[21] If the lender underwrites a loan that is inconsistent with the SBA's standards, the SBA may not honor the guaranty or may reduce the guaranty payment amount when the lender experiences a loss due to borrower default.[22] The primary reasons that the SBA would decline to honor its guaranty are related to incorrect loan eligibility determinations and inadequate documentation or support for eligibility determinations.[23] An SBA guaranty termination may pose risk to the bank, resulting in a loan balance in excess of the bank's legal lending limit under 12 CFR 32.

For construction loans made in connection with the 504 loan program, the CDC takeout is conditional. Banks are typically the sole lenders during the construction phase, and accordingly, they have heightened credit risk exposure. Because the CDC-provided loan is only funded when the project is completed and stabilized, credit risk can increase significantly during periods of real estate market instability.

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[21] SBA SOP 50 10 6, "Lender and Development Company Loan Programs," part 2, provides information about the SBA's requirements for credit standards, underwriting, credit analysis, personal guaranty, collateral, valuation, and environmental policies.

[22] Refer to 13 CFR 120.524 and SBA SOP 50 57 2, chapter 24, "Denial of Liability on 7(a) Guaranty." Full denial of an SBA guaranty is rare. Overall, the SBA honors about 97 percent of its guaranties, with repairs and partial denials accounting for the bulk of the remaining 3 percent.

[23] For more information about the SBA's lender supervision and enforcement processes, refer to SBA SOP 50 53 (2), "Supervision and Enforcement" (January 1, 2021).

Obtaining CDC takeout proceeds typically takes about 45 days while the CDC sells its debentures and ultimately funds its second-lien loan. The bank often extends a bridge loan to cover the financing gap during the CDC fund-raising phase. The disbursements advanced by the bank during the construction and bridge financing phases can be sizable.

Operational and Compliance Risks

An SBA lender faces operational risk when originating and servicing loans. The SBA guaranty, while an important loss mitigation feature, is conditional and necessitates significant documentation and administration efforts by the originating bank to ensure that the SBA will honor its guaranty. In addition, SBA lenders are required to service their entire SBA loan portfolios, including the portions they have sold, and provide a monthly report to SBA's fiscal and transfer agent.[24]

Common servicing challenges with SBA loans and reasons for SBA guaranty payment denials include inadequate documentation, inconsistent or missing documentation, releasing collateral without prior SBA approval when required, inappropriate loan modifications, and failure to report problem SBA-guaranteed credits to the SBA.[25] Other issues cited by the SBA include inadequate analysis of borrower repayment capacity, ineligible use of loan proceeds, inadequate support for meeting the "credit not available elsewhere" requirement, and loan disbursements made before executed franchise agreements.[26]

Delays in obtaining SBA approvals can present pipeline management challenges for loan originations or secondary market sales. For example, originations could be temporarily or permanently halted if the SBA runs out of funding during a fiscal year or during a federal government shutdown. In addition, a loss of delegated authority (including loss of preferred lender status)[27] with the SBA can result in a delay in obtaining loan approvals. Also, a need to resubmit documents for credit guaranty repair or a contested credit guaranty repair decision could present lengthy delays.

Banks may outsource SBA processing, implementation, and secondary market functions to third parties, a practice that can introduce additional operational risk.[28] The SBA requires a written

[24] Refer to SBA SOP 50 57 2, chapter 3, paragraph F.1.

[25] Refer to SBA SOP 50 57 2, chapter 24, for reasons of the SBA's denial of liability.

[26] Refer to SBA SOP 50 10 6, part 2, section A, chapter 1, paragraph D, for 7(a) loans and 504 loans.

[27] The SBA may designate experienced lenders as Preferred Lender Program (PLP) Lenders with delegated authority to process, close, service, and liquidate most SBA guaranteed loans without prior SBA review. Only banks that have PLP status may underwrite SBA loans without having to obtain prior SBA underwriting approval. For more information, refer to SBA SOP 50 10 6, part 1, section A, chapter 1, paragraph E, 2.

[28] For more information, refer to OCC Bulletin 2013-29, "Third-Party Relationships: Risk Management Guidance," and OCC Bulletin 2020-10, "Third-Party Relationships: Frequently Asked Questions to Supplement OCC Bulletin 2013-29."

agreement, accepted by the SBA, between the bank and the third party. [29] Banks that contract with a third party to assist with SBA lending functions still retain responsibility for evaluating, processing, closing, disbursing, servicing, liquidating, and litigating their SBA portfolio.[30]

Bank loans that are made under the SBA's 504 loan program are not guaranteed by the SBA and are thus subject to the supervisory loan-to-value (SLTV) limits under appendix A to 12 CFR 34, subpart D. The bank's exposure could potentially exceed the applicable SLTV limit. It may be appropriate in individual cases to originate loans with loan-to-value ratios in excess of the SLTV limits, based on the support provided by other mitigating credit factors, including the CDC takeout commitments. Loans exceeding the applicable SLTV limit should be included in the bank's SLTV exception tracking and board reporting.[31]

Liquidity and Price Risks

Liquidity risk is usually low for SBA lenders because of the SBA's unconditional guaranty of secondary market purchases and the ongoing demand for SBA-guaranteed loans by market participants. Rapid and uncontrolled growth could, however, create liquidity pressure exclusively within SBA lending, or in conjunction with other product growth initiatives. An economic downturn could reduce market participants' interest in purchasing SBA-guaranteed loans.

Banks that securitize the guaranteed portions of SBA loans and sell these securities in the secondary market may face liquidity risk because of the SBA's repurchase requirements if the underlying loans default. Servicing agreements require the selling bank to immediately repurchase the sold (guaranteed) portions within 60 days after borrower payment default, or request that the SBA repurchase the guaranteed portion of the loan.[32] In either case, the SBA could seek a reduction of the guaranty payment amount or deny the guaranty if the bank has not followed SBA requirements.

A bank can be suspended or barred from selling SBA-guaranteed loans in the secondary market if the SBA determines that the bank is in material noncompliance with the SBA's requirements.[33] A bank that has been suspended or barred could then face significant liquidity risk, particularly if it relies on selling SBA loans to meet liquidity needs.

Banks that depend on selling SBA-guaranteed loans in the secondary market for earnings and liquidity objectives can face price risk. Price risk can increase if the demand for SBA loans declines, resulting in a lower premium or longer holding periods for the selling bank.

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[29] Refer to SBA SOP 50 10 6, part 2, section A, chapter 5, paragraph D.

[30] Refer to 13 CFR 120.410. Also refer to SBA SOP 50 10 6, part 2, section A, chapter 5, paragraph D.

[31] Refer to 12 CFR 34, subpart D, appendix A, "Interagency Guidelines for Real Estate Lending," for mitigating credit factors that banks should have for loans with loan-to-value ratios exceeding the SLTV limits.

[32] Refer to SBA SOP 50 57 2, chapter 14, paragraph C. Also refer to SBA Form 1086, "Secondary Participation Guaranty Agreement."

[33] Refer to 13 CFR 120.660.

Strategic Risk

Banks are exposed to strategic risk when engaging in new, expanded, or modified SBA lending activities. Changes in market demand for SBA-guaranteed loan portions could make the activity no longer economical, as the benefits may not justify the risk in the retained unguaranteed portion.

Strategic risks are also present when banks acquire or merge with an existing SBA lender. The SBA does not permit SBA delegated lending authority to automatically transfer to an acquiring bank or the merged bank.[34] The SBA examines the new entity for SBA program compliance before granting SBA preferred lender status and lending authority.

Risk Management Principles

Strategic Planning

Banks specializing in SBA lending or secondary marketing or contemplating expanding into this area should develop a sound business strategy that addresses SBA lending, loan sales, and loan purchases, as applicable. A sound strategy outlines existing or planned activities, including how associated risks are managed and how planned lending, product growth, or acquisition activities are consistent with the bank's risk appetite, defined business goals, portfolio objectives, infrastructure capacity, and strategic and capital plans.[35]

The fact that SBA preferred lender status does not automatically transfer to any other lender is an important consideration in a bank's merger and acquisition due diligence, pricing, and integration assessments. Bank management's understanding of all aspects of SBA lending, including related rules and regulations, is critical before engaging with a specialized SBA lender or purchasing SBA loans or portfolios.

Policies and Processes

Effective SBA lending is supported by sound SBA lending policies and processes. The items and level of detail included should be commensurate with the nature and extent of the bank's SBA lending activities. Policies and processes should be consistent with the SBA's requirements and the bank's risk appetite. Sound processes include internal controls such as separation of duties, controls over appropriate financial reporting, and collateral tracking. Appropriate policies should typically address standards for

- underwriting and documentation, including
  - loan approval criteria, including the SBA's "credit not available elsewhere" eligibility requirement.

[34] Refer to SBA SOP 50 10 6, part 1, section A, chapter 1, E.

[35] Refer to OCC Bulletin 2017-43, "New, Modified, or Expanded Bank Products and Services: Risk Management Principles." For more information about strategic planning, refer to the "Corporate and Risk Governance" booklet of the *Comptroller's Handbook.*

- standards for credit analysis and financial due diligence.
- obtaining supportable and reasonable borrower projections.
- criteria and processes for collateral documentation and perfection of security interests.

- credit administration, including
  - ongoing loan monitoring.
  - exception tracking, especially for exceptions to SBA's requirements.
  - loan sales, purchasing, servicing, and resolution.
  - site inspections, as appropriate.
  - sound concentration risk management, including reasonable limits and identified correlations.
  - effective independent credit risk reviews, including reviews specific to 7(a) and 504 lending.
  - stress testing, as appropriate.
  - prudent construction loan risk management.
  - appropriate loan risk ratings.
  - robust troubled loan workout activities.
- risk management of third parties involved in the bank's SBA lending processes.
- accounting and regulatory reporting.

Personnel

A knowledgeable management team and experienced personnel with sufficient expertise, training, and familiarity with current SBA rules, regulations, policies, procedures, and guidance should support banks engaged in SBA lending. Personnel should receive adequate training to remain knowledgeable of changes to SBA loan program requirements, regardless of whether the bank's SBA-related functions are performed in-house or outsourced to third parties. Because of the complexity of SBA requirements, some banks engage legal professionals, accountants, and consultants specializing in SBA lending. These third parties should be managed in accordance with the bank's third-party risk management policies and processes. Appropriate compensation programs for lending personnel should be based on the overall risks and rewards of the bank's SBA lending activities and not be solely tied to the volume of loan originations or sales.[36]

Control Systems

Prudent control systems include quality control, quality assurance, independent credit risk review, and internal or external audit. Reviews and audits conducted by the SBA do not substitute for a bank's control systems.

Effective monitoring and reporting of SBA lending activities is important in enabling the bank to meet SBA reporting requirements. Timely reporting helps senior management and the board understand and proactively control (including mitigating) the risks in the bank's SBA lending activities, provide appropriate oversight, and provide credible challenge when warranted. Robust

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[36] Refer to the "Corporate and Risk Governance" booklet of the *Comptroller's Handbook* for more information regarding compensation. If the bank offers incentive compensation to employees involved in SBA lending, refer also to OCC Bulletin 2010-24, "Interagency Guidance on Sound Incentive Compensation Policies."

liquidity and pipeline management reporting can help a bank control risks associated with potential SBA funding and execution challenges.

Risk Rating SBA Loans

When risk rating an SBA loan,[37] the unguaranteed exposure should be assessed in conjunction with the guaranteed exposure. Repayment capacity should be assessed relative to the entire SBA obligation. Factors to consider when risk rating an SBA loan include

- primary source of repayment, such as cash flow from operations or conversion of assets.
- secondary sources of repayment, such as the willingness and ability of guarantors to support repayment, collateral support, and SBA guaranty, as applicable. The nature of the SBA guaranty as unconditional or conditional is an important consideration when determining the credit's risk rating.

In the presence of potential or well-defined weaknesses, the guaranteed portion of an SBA credit may carry a more favorable risk rating than the unguaranteed portion depending on whether the guaranty is conditional or unconditional.

For portions of loans and securities purchased in the secondary market that carry a full, unconditional SBA guaranty, the guaranteed portions should be risk rated as pass.

For SBA-guaranteed portions held by the originating bank, the SBA guaranty is conditional and should be evaluated as such. The conditional SBA guaranty generally still supports a pass rating for the SBA-guaranteed amount.[38] Certain weaknesses, however, could warrant a more adverse risk rating for the conditionally guaranteed amount. For example, a bank could have documentation weaknesses that have been exacerbated by inadequate risk management. In this situation, even though there may not be a payment default[39] or SBA guaranty denial, the potential or actual documentation and risk management weakness could cause the SBA to not honor the guaranty. As a result, the potential or actual weakness could warrant a risk rating below pass. Depending on the specific facts and circumstances, the conditionally guaranteed portion could be classified substandard or worse, consistent with the risk rating of the unguaranteed portion. For example, a substandard or worse classification could be warranted if the bank is experiencing defaults in conjunction with non-compliance with SBA requirements or inadequate risk management, or if the SBA has denied liability or demanded a reduction in the guaranty payment.

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[37] For information on credit risk ratings, refer to the "Rating Credit Risk" booklet of the *Comptroller's Handbook*.

[38] For example, $750,000, or 75 percent, of an SBA 7(a) loan with a $1 million outstanding balance may be rated pass, even though the remaining $250,000 unguaranteed portion is to be rated special mention or worse.

[39] The SBA may not allow banks to accelerate foreclosure actions based on a covenant default by the borrower alone, such as failure to provide timely financial statements, and may not allow the SBA loan agreement to contain any financial maintenance covenants that could potentially trigger acceleration by the lender other than for payment delinquency of 60 days or more. Refer to SBA SOP 50 57 2, chapter 14.

For real estate construction loans advanced in connection with the 504 loan program, the risk rating should take into account whether the CDC takeout has occurred or is likely to occur.

Credit Loss Allowance

Banks should maintain an appropriate methodology and balance for the credit loss allowance related to SBA loans held in the bank's portfolio. The bank's methodology should identify the differences in credit risk between the guaranteed and the unguaranteed portions of SBA loans, and the differences between the SBA's conditional and unconditional guaranty, and accordingly establish an appropriate allowance. The bank's credit loss methodology applied to SBA loans should also consider the bank's number of "repairs" or "denials" [40], and assess the lender's "24 Month Repair/Denial Rate"[41] and the loss rate for the overall 7(a) portfolio.

Banks that service SBA-guaranteed loans for others should record an appropriate off-balance-sheet liability for contingent losses, if necessary.

Concentration Risk Management

Concentration risk management practices should be commensurate with the bank's SBA loan exposures. Concentration risk management is important for banks with an originate-to-distribute business model, as these banks' exposures are centered in unguaranteed portions with higher credit risk. Unguaranteed portions of SBA loans should be adequately identified and monitored to control associated credit and liquidity risks.

Construction and bridge loans related to the 504 loan program generally should be monitored as separate categories with appropriate concentration limits or sublimits. Determining reasonable sublimits for pipeline exposures, held positions, and unguaranteed portions can be an ongoing challenge and is affected by the nature and extent of the bank's SBA lending activities. It may be useful for bank management to analyze the same risk factors that can affect other loan portfolios, such as industry, geography, collateral, sourcing, and liquidity, for the purpose of setting appropriate concentration limits and sublimits.

It is important for bank management to understand correlations between SBA exposure and other asset pools because positive correlation can diminish the benefits of portfolio granularity derived from holding small-dollar SBA positions. Proactive and dynamic concentration management includes adjusting underwriting criteria, reducing exposures, or deploying additional capital in advance of any significant increases in credit risk such as a rising concentration in unguaranteed

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[40] "Repair" is an agreement between the lender participant and the SBA for the SBA to deduct a specified amount from the SBA's payment when it is requested to purchase the guaranty from the lender participant. The deduction amount compensates the SBA for actual or anticipated loss due to the lender participant's actions or omissions, such as when a lender participant fails to perfect a security interest. "Denial" occurs when the SBA formally denies its liability on the guaranty, either partially or fully, in cases in which the lender's actions or omissions caused a total or near total loss on the loan. The lender participant will absorb losses for "repairs" or "denials." For more information, refer to SBA SOP 50 57 2, "7(a) Loan Servicing and Liquidation."

[41] This rate is the bank's repair or denial amount divided by gross SBA purchase amount over the past 24 months.

SBA exposures. When establishing concentration limits, it is important to recognize that there may be limited options to reduce exposures, particularly in distressed markets.

Stress Testing

Stress testing is an important part of a bank's capital and strategic planning. Depending on the size (including concentrations) and complexity of a bank's SBA exposure, it may be prudent for the bank to implement loan- and portfolio-level stress testing. A bank can implement risk-based stress testing at origination and at periodic intervals. For a bank with significant concentrations, concentration limits should be stressed and reassessed when there is a significant change in relevant risk factors.

Regulatory Reporting

SBA loans, both the guaranteed and unguaranteed amounts, should be reported with other loans under the appropriate loan categories in Schedule RC-C of the Consolidated Reports of Condition and Income (call report). The guaranteed portions are reported as follows:

- The guaranteed portion of held-for-sale and held-for-investment SBA loans are reported in Schedule RC-R, column G (20 percent risk weight), items 4.d and 5.d, respectively.
- Guaranteed Interest Certificates are reported in Schedule RC-R, column C (0 percent risk weight), items 4.d (held-for-sale) and 5.d (held-for-investment).

Guaranteed Loan Pool Certificates are reported under the securities sections of the call report in Schedule RC-B, item 2, or, if held for trading, in Schedule RC, item 5.

The delinquency and nonaccrual status of SBA loans should be reported in the bank's call report, consistent with reporting of all other loans.

First-lien bank loans made under the 504 loan program must be reported in accordance with the respective call report instructions for the loans or collateral, consistent with the reporting of other commercial loans. This includes hotel and motel loan financings, which should be reported as non-owner-occupied, nonfarm, nonresidential real estate loans.[42]

Capital Considerations

Banks should have adequate capital to support their overall SBA exposures, particularly the unguaranteed portions. The guaranteed portion of the SBA loan receives favorable regulatory capital treatments. Under the current standardized approach of the capital rule,[43] the risk weight is 0 percent for Guaranteed Interest Certificates, while the risk weight is 20 percent for the

[42] Refer to call report instructions, Schedule RC-C 1.e.(1), 1.e.(2).

[43] Refer to 12 CFR 3, "Capital Adequacy Standards."

guaranteed loan amount originated and held by the bank.[44] The non-guaranteed loan amount generally has the same risk weight as the bank's other non-SBA loans, typically 100 percent, or 150 percent if past-due. The risk-weight treatment only applies to banks that calculate and report risk-based capital.

Qualifying community banks that elect to use the community bank leverage ratio framework[45] and that maintain a leverage ratio of greater than 9 percent are considered to have satisfied the risk-based and leverage capital requirements in the OCC's capital rules. The guaranteed and unguaranteed portions of SBA loans and SBA Guaranteed Interest Certificates that are reported on the call report are included in the denominator (average total consolidated assets) of the leverage ratio.[46]

Accounting for SBA Loan Sales and Assets

When a bank sells an SBA-guaranteed loan in whole or in part, the sale is subject to certain accounting standards regarding sales treatment, income recognition, and fair value measurement. Accounting Standards Codification (ASC) Topic 860, "Transfers and Servicing," and the call report instructions cover this topic.

When selling the SBA-guaranteed portion, the selling bank records a servicing asset representing its right to service the portion sold. For example, if the selling bank typically receives a servicing fee of 1 percent on an annualized basis and the current industry norm for servicing compensation is 40 basis points, the present value of the remaining 60 basis points is recorded as a servicing asset at its fair value at the time of sale.

The servicing asset is subsequently accounted for according to ASC 860, which allows the use of either the amortization or the fair value method. Under the amortization method, the servicing asset is carried at the lower of amortized cost or fair value. The servicing asset is amortized using the level yield method over the period of estimated servicing income, and it is assessed for impairment each reporting period. Under the fair value method, the servicing asset is measured at fair value each reporting period, with changes in fair value reported in income, and there is no associated allowance for credit loss on the servicing asset.

[44] The temporary Paycheck Protection Program (PPP) loans made during the COVID-19 pandemic also receive a 0 percent risk weight. Refer to 12 CFR 3.32(a)(1).

[45] Refer to the *Community Bank Leverage Ratio Framework: Community Bank Compliance Guide* (October 2019), which was produced by the OCC, the Board of Governors of the Federal Reserve System, and the Federal Deposit Insurance Corporation.

[46] PPP loans pledged as collateral for a non-recourse loan from the Federal Reserve's PPP Liquidity Facility (PPPLF) are not subject to the leverage capital requirements. A bank may exclude PPP loans pledged to the PPPLF from average total consolidated assets and total leverage exposure. Refer to OCC Bulletin 2020-96, "Capital and Liquidity Treatment for Money Market Liquidity Facility and Paycheck Protection Program: Final Rule."

Resources

OCC, *Community Developments Insights*, "Bankers' Guide to the SBA 7(a) Loan Guaranty Program"
OCC, *Community Developments Fact Sheet*, "What Is the SBA 7(a) Loan Guaranty Program?"
OCC, *Community Developments Fact Sheet*, "SBA Certified Development Company/504 Loan Program"
OCC, *Community Developments Insights*, "SBA's Certified Development Company/504 Loan Program: Small Businesses' Window to Wall Street"
SBA SOP 50 53 (2), "Supervision and Enforcement" (January 1, 2021)
SBA SOP 50 55, "504 Loan Servicing and Liquidation" (October 1, 2013)
SBA SOP 50 57 2, "7(a) Loan Servicing and Liquidation" (December 1, 2015)
SBA Office of Inspector General Report 19-19, "High Risk 7(a) Loan Review Program" (September 19, 2019)
SBA SOP 50 10 6, "Lender and Development Company Loan Programs" (October 1, 2020)
Financial Accounting Standards Board's ASC Subtopic 860-20, "Transfers and Servicing—Sales of Financial Assets"
FFIEC Instructions for Preparation of Consolidated Reports of Condition and Income