SBA 7(a) Program

Program Description

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1 Program Overview

The section 7(a) program is the Small Business Administration's (SBA) primary loan program. Under the 7(a) program, small business borrowers obtain loans from commercial lenders and SBA guarantees a percentage of the loan against borrower default. Financing obtained under the 7(a) program can be used for a wide range of business purposes, including working capital, acquisition of fixed assets, and others.

1.1 Program History

The 7(a) program was established in 1953 by the Small Business Act. At its inception, the program comprised three types of financing. SBA lent money directly to businesses under a direct loan program. An immediate participation loan program allowed businesses to obtain a loan package funded jointly by SBA and a private lender. SBA also guaranteed loans made by private lenders. In 1968, SBA began a transition from direct loans to guarantee loans. Currently, SBA offers only guarantee loans through the 7(a) program.

Other major changes to the program over time are:

- 1979: Established 1% guarantee fee, which cannot be passed through to the borrower (allowed to pass through in 1980) and a 90% guarantee on all loans.
- 1991: Section 504 of the Federal Credit Reform Act of 1990 requires that direct loans and loan guarantee commitments be made only to the extent that appropriations have been made in advance for their cost.
- 1992: Loan amounts exceeding $155,000 guaranteed between 70% and 85% (compared to $255,000 in 1986). No annual fees or fees for loans sold on secondary market.
- 1992: Under the Preferred Lenders Program (PLP), loans are not subject to SBA's minimum guarantee percentages and can have a maximum 80% guarantee.
- 1992: Loan maturity maximum is set to 25 years.
- 1995 SBA Express program was implemented.
- 1998: Lenders service all loans and liquidate business chattel prior to SBA purchase (for new loans only)
- 1999: Proposed change in structure of upfront fee and ongoing (annual fee) based on size.
- December 21, 2000: Under provisions of the Small Business Reauthorization Act of 2000, SBA guarantees up to $1,000,000 of a private sector loan of up to $2,000,000. The SBA also guarantees up to 85% on loans of $150,000 or less and 75% on loans greater than $150,000.
- 2001: HR2615 authorizes banks to keep up to 25% of upfront fee for loans less than $150,000.
- 2001: Prepayment penalty initiated on loans with maturities of 15 years or greater.
- 2004: The guarantee limit increased from $1M to $1.5M.
- 2004: Combination financing authorized in statute (making official SBA's previous "piggyback" program) where a borrower's financing may be comprised of both a 7(a) guaranteed loan and a commercial loan.

1.2 Borrower and project eligibility

To qualify for the 7(a) program, a borrower must meet a number of eligibility criteria. First, borrowers must be for-profit businesses that are considered small based on SBA size requirements. Second, borrowers must demonstrate a need for financing. Third, 7(a) loans must be used to establish a new business or to assist in the operation, acquisition, or expansion of an existing business.

Business size. Eligible small businesses must be independently owned and operated, and not dominant in their fields of operation. Specific size guidelines vary from industry to industry and are based on number of employees or average annual receipts.

Need. SBA provides 7(a) guarantees only on loans that would not otherwise be made by lenders. Also, funds obtained through the program must not be available to borrowers from sources internal to the business or business owners. Related to this, SBA requires that owners of 20 percent or more of the business personally guarantee loan repayment.

Use of proceeds. SBA requires that loan proceeds be used to establish a new business or to assist in the operation, acquisition, or expansion of an existing business. Within this general framework, borrowers may use funds for a variety of purposes. These include:

- Acquire, develop, or improve a business site
- Acquire and install fixed assets
- Purchase inventory, supplies, and raw materials
- Acquire other businesses
- Refinance certain outstanding debts, under certain conditions

Loan proceeds may not be used to finance real property that will be used for investment purposes.

1.3 Loan Terms

We describe the structure of SBA 7(a) loans in terms of loan amount and guarantee percentage, interest rates, maturity, and collateral. A majority of 7(a) loans are traditional fixed maturity loans with a single disbursement and repayment schedule, however, in recent years revolving lines of credit have become more prevalent.

Loan amount and guarantee percentage. Under the 7(a) program, businesses may receive a loan up to $2 million. SBA guarantees a percentage of this total amount based on the size of the loan and whether it was originated under the SBA Express program. The guarantee percentage on all SBA Express loans is 50 percent at maximum, regardless of size. For non-SBA Express loans, maximum guarantee percentages are:

- For loans with a disbursed amount less than or equal to $150,000, the maximum guarantee is 80 percent.
- For loans with a disbursed amount greater than $150,000 and less than $2 million, the maximum guarantee is 75 percent.

Loan interest rates. Interest rates on 7(a) loans may be variable or fixed. Rates are negotiated between the borrower and the lender, subject to SBA-imposed maximums. SBA requires that fixed interest rates do not exceed the prime rate plus a spread that varies from 225 to 475 basis points (bps) depending on loan size and term. Variable rate loans must be pegged to either the lowest prime rate or an SBA optional peg rate. The optional peg rate is a weighted average of interest rates on Treasury securities with maturities similar to the average SBA loan, as published in the Federal Register quarterly. Lenders may offer interest rate caps or floors on 7(a) loans.

Maturity. Generally, loan maturity is negotiated between borrowers and lenders based on the borrower's ability to repay, use of loan proceeds, and expected life of any assets financed. However, maturities are subject to SBA-imposed limits. Maturity limits are 25 years for projects backed by real estate, and 7 to 10 years for working capital projects.

Collateral. Collateral is specific to the loan and type of business financed, but may include real estate, machinery, or other business assets.[1] In addition, SBA requires that any individuals who own 20 percent or more of the business personally guarantee repayment.

[1] For some business types, little physical collateral may exist.

1.4 Subprograms within 7(a)

SBA offers several specialized programs as subsets of the 7(a) program. We describe the Defense Loan and Technical Assistance Program (DELTA), SBA Express, Supplemental Terrorist Activity Relief (STAR), and Community Adjustment and Investment Program (CAIP).

DELTA. The DELTA program is designed to help defense industry-dependent small businesses that have been adversely affected by defense cuts to diversify into the commercial market. Eligible businesses must have derived at least 25 percent of their total revenue during any one of the previous five operating years from Department of Defense contracts or defense-related Department of Energy contracts.

STAR. Under the STAR program, small businesses that were adversely affected by the terrorist attacks of September 11, 2001 are eligible for a reduced ongoing fee.[2] Recognized adverse effects include difficulty to service existing debt; pay employees or vendors; purchase materials, supplies, or inventory; pay rents, mortgages, or other operating expenses; and to secure financing. This fee reduction was effective for the full term of eligible loans approved by SBA during the period between January 11, 2002 and January 10, 2003.

CAIP. CAIP assists U.S. companies that are doing business in areas of the country that have been negatively affected by NAFTA. Funds administered by Treasury allow for the payment of fees on eligible loans. These fees include the 7(a) program guarantee fee (and subsidy) and the 504 program guarantee, CDC and lender fees.

SBA Express. The SBA Express program began in 1995. Under SBA Express, selected lenders are allowed expedited loan application and processing in return for accepting a 50 percent guarantee. SBA provides a response within 36 hours of receiving the complete application package. Lenders use their own procedures and paperwork to approve and service Express loans.

Community Express. The Community Express program began in 2003. Community Express are working capital loans up to $50,000 that receive expedited processing similar to SBA Express loans. Community Express loans are available to people and place-based markets designated as underserved by SBA.

Preferred Lender Program. The Preferred Lending Program incorporates banks that SBA has deemed to be proficiency in processing and servicing SBA-guaranteed loans. Preferred lenders are required to liquidate 7(a) loans.

2 Business Processes

The responsibilities for the business processes associated with the 7(a) loan program are assumed by lenders and the SBA. Lenders are responsible for marketing loans to small businesses, collecting applications for loans, developing the criteria to accept or reject an application, servicing loans, and resolving delinquent loans. The primary responsibilities of SBA are to provide loan guarantees, approve lenders for the program, and to oversee the life cycle of guaranteed loans.

2.1 Marketing

Lenders market the 7(a) program directly to small businesses while SBA's primary marketing responsibility is to promote the 7(a) program to lenders. SBA also supports a national network of Small Business Development Centers (SBDC) where businesses can obtain detailed information about SBA programs, including 7(a).

In order to qualify to do business under the 7(a) loan program, SBA must determine that a lender has a continuing ability to underwrite, close, disburse, service, and liquidate small business loans, good character and reputation, and that the lender is supervised and examined by a State or

[2] Ongoing fee is reduced from 50 bps to 25 bps of the outstanding guaranteed loan balance.

Federal regulatory authority. Most lenders are American banks. However, there are some non-bank lenders, for example credit unions and finance companies.

2.2 Application, Underwriting, and Approval

Businesses seeking financing under the 7(a) program apply for a loan with a qualified lender. Lenders are allowed to request a 7(a) guarantee only for loan applications that would be rejected without a guarantee. The borrower completes an application that describes the history and nature of the business, the amount and purpose of the loan, collateral, business financial statements or tax returns, and a business plan.

The primary consideration in SBA's decision to guarantee a loan is repayment ability. Additional factors include management capability, collateral, and the business owner's equity contribution. Owners of 20 percent or more of the business must personally guarantee repayment of the loan.

The length of time from application to approval decision depends on the type of loan. The majority of lenders receive notice of approval or denial from the SBA within 10 days. Average approval time is 1 day for Preferred Lending Program (PLP) loans.

SBA is not involved in the approval decision for 85 percent of approvals. In 15 percent of approvals, SBA makes the secondary decision. In these cases, lenders first approve the loan, and then SBA may uphold or overturn the approval.

SBA requires that the borrower, or the business itself, use personal resources to reduce the SBA funded portion of the total financing package (i.e., any SBA loans and any other financing, including loans from any other source) when the owners' liquid assets exceed the amounts specified below:

- $250,000 or less: each 20% owner of the applicant must inject any personal liquid assets which are in excess of two times the total financing package or $100,000, whichever is greater.
- Between $250,001 and $500,000: each 20% owner of the applicant must inject any personal liquid assets which are in excess of one and one-half times the total financing package or $500,000, whichever is greater.
- Exceeds $500,000: each 20% owner of the applicant must inject any personal liquid assets which are in excess of one times the total financing package or $750,000, whichever is greater.

In addition, SBA requires that holders of at least 20 percent ownership of the company guarantee the loan from the lender by using the business and its assets as collateral. SBA may require other appropriate individuals to guarantee the loan as well. However, SBA does not require personal guarantees from those with less than 5% ownership.

2.3 Disbursement

Before funds can be disbursed, certain conditions must be met. First, SBA must receive all of the completed loan authorization forms. These forms include the financial statement, brief history of the business, and a Certificate of Doing Business. Second, the borrower must fulfill certain conditions stated in the loan authorization, such as obtaining necessary licenses or permits, completing all or a portion of a construction project, obtaining and installing necessary machinery and equipment, or completing the purchase of a business. The average time it takes for funds to be disbursed is between three to six months. The time for disbursement is independent from the approval process, which takes 2 to 10 days.

Funds are disbursed to about 90 percent of the applicants on average. The remaining 10 percent of funds account for cancelled loan approvals. Funds allocated to loans that are cancelled can be recycled back into the program and used for disbursements for other applicants (subject to the availability of the funds per budget rules).

2.4 Servicing

Servicing procedures differ depending on whether loans are performing, delinquent, or in workout or liquidation.

2.4.1 Performing Loans

Generally, lenders service their own portfolios of 7(a) loans. This involves collecting principal and interest payments, fees, and submitting loan-level information monthly to SBA using Form 1502. Form 1502 captures information about loan characteristics, performance status, and monthly loan transactions.

SBA retains a Centralized Servicing Agent (CSA) to collect and process fee remittances and monthly Form 1502 submissions. Lenders remit fees and submit 1502s to the CSA—the CSA advances these to SBA.

2.4.2 Delinquency and Workout

A loan is delinquent if the borrower fails to make a scheduled payment on time. Lenders are responsible for resolving loan delinquencies. Generally, this involves developing a workout plan that allows borrowers to catch up on their payments. The workout plan may include modifications to certain aspects of loan structure such as a different interest rate or loan term. While these changes do not require SBA approval, the lender must notify SBA of any changes. Loans that are delinquent more than 60 days are eligible for purchase by SBA.

2.4.3 Purchase

A lender may request that SBA honor its guarantee by purchasing a defaulted loan if a borrower is in default on any installment for more than 60 calendar days. To request purchase, lenders assemble the required documentation and submit it with a demand letter. The documentation must demonstrate that all the requirements of the loan authorization have been met.

If the defaulted loan had previously been sold and is held by secondary market investors, SBA will purchase 100 percent of the unpaid interest accrued to the purchase date. For loans still held by their originating lenders, SBA purchases a maximum of 120 days of accrued interest.

2.4.4 Liquidation and Recovery

Lenders are typically responsible to liquidate defaulted 7(a) loans in an attempt to recover cash to satisfy the borrower's debt. For each loan, the lender is required to execute a Certificate of Interest that shows SBA's percentage interest in the loan and to submit a liquidation plan. The lender then executes the plan, sharing all recoveries with SBA based on SBA's relative guarantee percentage.

In rare circumstances SBA may choose to liquidate defaulted loans directly—this may occur, for instance, if allowing the lender to liquidate the loan would create a potential conflict of interest with the lender's non-SBA portfolio.

3 Loan Termination

SBA's guarantee is terminated when 7(a) loans prepay, are purchased, or pay off at maturity.

Prepayment. Borrowers may prepay their loans in full or in part at any time by remitting the remaining principal balance and accrued interest to lenders. However, loans applied for on or after December 22, 2000 are subject to a prepayment penalty under the following conditions:[3]

- Loan term is 15 years or more
- Prepayment occurs within 3 years of first loan disbursement

[3] The prepayment penalty is also referred to as a subsidy recoupment fee.

- Prepayment is voluntarily
- Prepayment amount exceeds 25 percent of the outstanding loan balance

The prepayment penalty is paid by the borrower to SBA as a percentage of the guaranteed portion of the prepaid amount. The prepayment penalty percentage declines over the first three years after disbursement— it is equal to 5 percent in the first year after disbursement, 3 percent in the second year, and 1 percent in the third year.

Purchase. A lender may request that SBA honor its guarantee if a borrower is in default on any installment for more than 60 calendar days and the default has not been cured.[4] If a borrower cures default before a lender requests purchase by SBA, the lender's right to request purchase on that default lapses. Lenders request purchase by submitting a demand letter, with required documentation, to SBA. To execute the purchase, SBA remits payment to the lender in an amount equal to the guaranteed principal portion of the loan and accrued interest on the guaranteed principal. In addition, SBA retains the right to purchase a guaranteed portion of a loan at any time.

Maturity. Loans guaranteed under the 7(a) program are fully amortizing. Loans not prepaid or purchased make their final payment of principal and interest to lenders at maturity. Loans structured as revolving lines of credit have maximum maturities set by SBA, but because each loan is tailored to an individual borrower's needs, initial maturities may be shorter than the maximum.

4 Program Fees and Cash Flows

Table 1 lists all fees collected by the different parties involved in the SBA 7(a) program, as well as all program cash flows paid to or received by SBA. Table 2 lists historical ongoing and upfront fee rates by cohort.

Table 1. 7(a) program fees and cash flows

Party to cash flow	Cash flow	Inflow/ outflow	Description
Lender	Service Fee	Inflow	Lenders may charge loan applicants a service fee not to exceed 2 percent per year on the outstanding balance of a loan that requires special servicing. Assessment of this fee is subject to prior written SBA approval.
Lender	Packaging Fee	Inflow	Lender may charge an applicant reasonable fees for packaging and other services to the borrower
Lender	Recording Fee	Inflow	Lender may collect from the applicant necessary out-of-pocket expenses such as filing fees associated with loan origination
Lender	Late Payment Fee	Inflow	Late payment fee assessed to the borrower, not to exceed 5 percent of the delinquent loan payment
SBA	Guarantee Fee	Inflow	SBA assesses an upfront fee to lenders in return for its guarantee. The guarantee fee is assessed at disbursement, as a percentage of the guaranteed amount disbursed.
SBA	Ongoing Fee	Inflow	An annual fee based on the outstanding balance of the guaranteed portion of each loan, paid by the lender on a monthly basis
SBA	Late Fee	Inflow	SBA may institute a late fee charge for delinquent payments of the ongoing fee to cover administrative costs associated with collecting delinquent fees
SBA	Subsidy Recoupment Fee	Inflow	SBA assesses and collects prepayment penalties on loans with maturities 15 years or greater that are prepaid within three years of disbursement. Assessed as a percentage of the prepaid amount.

[4] Under certain circumstances, SBA may purchase loans that are less than 60 days past due.

Party to cash flow	Cash flow	Inflow/ outflow	Description
SBA	Delinquency Fee	Inflow	Fee assessed to lenders for late payment
SBA	Purchase	Outflow	SBA honors its guarantee by purchasing the guaranteed portions of defaulted loans from lenders. The purchase amount includes guaranteed principal and accrued interest.
SBA	Recovery	Inflow / Outflow	Lenders pursue recoveries from defaulted borrowers and share proceeds with SBA based on guarantee percentage. SBA may also incur expenses related to pursuit of recovery.

Table 2. 7(a) ongoing and upfront fees by cohort

Cohort	Ongoing fee rate	Upfront fee rate, approval amount less than or equal to $150k[5]	Upfront fee rate, approval amount between $150k and $700k	Upfront fee rate, approval amount is greater than $700k	Upfront fee rate, loan term is less than 1 year	Additional upfront fee rate on approval amount > $1M
1992	0.000%	2.000%	3.000%	3.500%	0.250%	0.000%
1993	0.400%[6]	2.000%	3.000%	3.500%	0.250%	0.000%
1994	0.400%[6]	2.000%	3.000%	3.500%	0.250%	0.000%
1995	0.400%[6]	2.000%	3.000%	3.500%	0.250%	0.000%
1996	0.500%	2.000%	3.000%	3.500%	0.250%	0.000%
1997	0.500%	2.000%	3.000%	3.500%	0.250%	0.000%
1998	0.500%	2.000%	3.000%	3.500%	0.250%	0.000%
1999	0.500%	2.000%	3.000%	3.500%	0.250%	0.000%
2000	0.500%	2.000%	3.000%	3.500%	0.250%	0.000%
2001	0.500%	2.000%	3.000%	3.500%	0.250%	0.000%
2002	0.500%[7]	2.000%	3.000%	3.500%	0.250%	0.000%
2003	0.250%	1.000%	2.500%	3.500%	0.250%	0.000%
2004	0.250%, 0.360%[8]	1.000%	2.500%	3.500%	0.250%	0.250%
2005	0.500%	2.000%	3.000%	3.500%	0.250%	0.250%
2006	0.545%	2.000%	3.000%	3.500%	0.250%	0.250%
2007	0.550%	2.000%	3.000%	3.500%	0.250%	0.250%
2008	0.494%	2.000%	3.000%	3.500%	0.250%	0.250%

[5] SBA only receives 75% of the upfront fee on loans of $150,000 or less.

[6] The ongoing fee rate for the 1993 through 1995 cohorts only apply to loans sold to the secondary market.

[7] Star loans pay an annual fee of 0.250%.

[8] The ongoing fee rate for loans approved from October 1, 2003 to April 4, 2004 is 0.250%. The ongoing fee rate for loan approved after April 4, 2004 was 0.360%.