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SBA 7(a) Loan Program

The Small Business Administration (SBA) is a government agency that works with lenders to provide loans to small business borrowers who comply with its eligibility requirements. The SBA 7(a) loan program is the agency's primary program for providing financial assistance to creditworthy small businesses when they cannot otherwise obtain credit at reasonable terms. Target 7(a) loan recipients include start-up businesses with weaknesses in their loan applications. Proceeds may be used to establish a new business or to assist in the operation, acquisition, or expansion of an existing business.

The SBA provides a guarantee on 75% of the loan (85% for smaller loans), leaving the lender with 25% exposure, incentivizing prudent lending decisions. The securities are backed by the full faith and credit of the United States government. In FY2018, the SBA approved 60,353 7(a) loans totaling nearly $25.4bn. Also, in FY18, the average approved 7(a) loan amount was $420,401 with about 36% of all 7(a) loans exceeding $2mn. Congress has continuously increased the 7(a) program's authorization limit, progressing from $18.75bn (on disbursements) in FY2014 to $23.5bn in FY2015, $26.5bn in FY2016, $27.5bn in FY2017, and $29.0bn in FY2018.

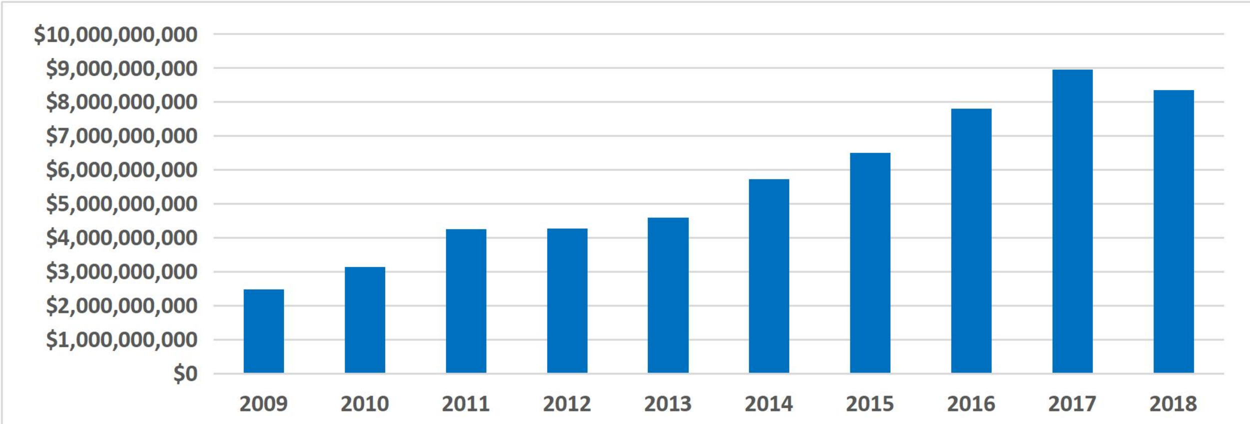
SBA 7(a) loans generally have repayment periods between 7-25 years and $5mn is the maximum loan amount. Most SBA 7(a) loans currently have interest rates between 7.25% and 9.75%, depending on loan size and maturity. Prepayment penalties apply to longer-term SBA 7(a) loans (15 years or longer) and take the form of 5%-3%-1% penalties in the first 3 years, respectively. Small businesses utilize loans of up to 10 years for equipment and working capital and terms of up to 25 years for real estate. Business owners are expected to make all business assets available as collateral for SBA 7(a) loans. The SBA can register liens on home or other personal property.

SBA 7(a) Loan Pools:

SBA loan pools reflected a small fraction of the total US asset backed security market as of year-end 2018. According to Securities Industry and Financial Markets Association (SIFMA), total ABS outstanding attributed to the SBA amounted to $36.3bn as of end-2018. This represented 2.2% of the $1.7trn in US asset backed securities outstanding.

Lenders may opt to sell the guaranteed portion of the 7(a) loans (i.e. 75% of the loan) into the secondary market. Assemblers subsequently pool the loans into SBA guaranteed 7(a) pool securities and sell them to institutional investors. This whitepaper focuses on par pools as opposed to premium pools. SBA 7(a) loan pools provide regularly scheduled payments of principal and interest. The vast majority are quarterly variable rate securities tied to the prime rate (the average par pool has an annual coupon of Prime minus 260 basis points that pays quarterly). Given their floating coupon payments, the securities are low duration and prove popular with banks due to counting as 0% on risk weighted assets (RWA). The securities are generally pledgeable as collateral for Public Funds, Federal Reserve and Federal Home Loan Bank advances, and Treasury, Tax and Loan accounts.

Chart 1: SBA 7(a) Pool Issuance



Source: Bloomberg

Since principal and interest are guaranteed, the primary risk is the return of principal dollars earlier than anticipated (prepayment risk). Sources of prepayment can be voluntary (refinance) or involuntary (default). Prepayments are aggressive after the penalty period falls away following year 3. Prepayments also rise when the yield curve flattens (ie. prime rate increases and longer-term rates fall) as traditional bank loans become more attractive. In addition, with a newly established operating and credit history the business can secure better credit terms after 2-3 years.

94% of 2017 7(a) loan pool issuance fell in two major weighted average maturity (WAM) buckets:

- 8-11 year (Equipment/Working Capital) – 39% of 2017 issuance.
- 21+ year (Real Estate) – 55% of 2017 issuance.

There are 7(a) loan pools with maturities of 5 years or less available on the secondary market, but most have already prepaid a majority of their underlying loans and are likely to continue to prepay quickly. 8-11 year loans do not have prepayment penalties in the first 3 years like the longer-term real estate loans. They are thus likely to get depleted more quickly.

Table 1: SBA Pool Prepayments; Jan 2019

	SBA Pools		Latest Factor: Jan 2019							ALL Variable Rate Pools					
Issue	Num	$Mil			YTD		Calendar Year Historical CPR								
Date	Pool	Cur	Orig	Life	2019	2018	2017	2016	2015	2014	2013	2012	2011	2010	2009
2019	0	0	0												
2018	292	8133	8492	3.7	2.5	3.8									
2017	298	7515	8948	7.2	10.8	7.9	3.3								
2016	293	5294	7760	10.6	17.6	15.7	6.5	2.3							
2015	289	3294	6476	13.8	18.4	22.7	12.8	6.7	3.1						
2014	258	2343	5704	14.0	16.1	23.8	16.4	10.4	5.8	3.6					
2013	222	1539	4557	14.0	22.9	25.0	13.4	13.5	10.5	6.6	2.7				
2012	239	1210	4265	13.5	15.2	24.4	13.9	10.5	14.1	11	5.4	2.4			
2011	276	1099	4270	12.3	13.7	23.8	11.6	7.9	12.2	12.2	10.2	4.6	1.8		
2010	289	707	3382	11.7	15.5	24.7	11.4	7.0	8.4	10.6	11.9	7.7	5.0	3.8	
2009	258	508	2820	12.0	10.3	24.2	10.2	6.8	6.1	7.7	8.9	8.5	8.4	7.4	4.9
Total															
	2714	31642	56674	12.3	12.1	16.3	10.6	8.4	8.7	8.8	8.0	5.9	5.3	6.2	4.9

Source: Bloomberg

The table above summarizes historical prepayments. Pools are displayed by issuance year in the column on the left with their lifetime constant prepayment rates (CPR) in the corresponding row cells. For example, the 2009 SBA pools pre-paid 4.9 CPR in year 1, followed by 7.4, 8.4, 8.5, 8.9 CPR in the following four years (from 2010 to 2013) and then slowed to 7.7 and 6.1 CPR in 2014 and 2015. In October 2017, the SBA changed the way excess amortization is remitted to pool holders. Prior to the rule change, excess principal accumulated over time and was paid out when the last loan paid off or the pool matured. The rule change has inflated prepayment rates from 2017 onwards for securities issued prior to October 2017. This is because excess principal within each pool was suddenly reallocated (pro rata) to unpaid loans in the pool as they prepaid and were passed through. This can be seen by the spike in CPRs in 2017 and 2018 across vintages.

We would expect a reversion to more normal prepayment patterns for securities issued after the rule change because everything is passed through as it is prepaid (there is no excess amortization build up within the pools). Notice the mid-2016 snapshot of the SBA Pool Prepayments table below. This table portrays a more normal prepayment pattern for the 7(a) securities. The tendency is for low prepayments (due to the business just getting started as well as penalties) to tick higher after 2-3 years and then to drop off to a more level rate.

Table 2: SBA Pool Prepayments; Mid-2016

SBA Pools			Latest Factor: Mid-2016								ALL Variable Rate Pools				
Issue	Num	$Mil			YTD		Calendar Year Historical CPR								
Date	Pool	Cur	Orig	Life	2016	2015	2014	2013	2012	2011	2010	2009	2008	2007	2006
2016	126	2979	3018	0.5	0.5										
2015	289	5942	6476	4.6	5.5	3.1									
2014	258	4594	5704	6.6	9.2	5.8	3.6								
2013	222	3059	4557	8.8	12.7	10.5	6.6	2.7							
2012	239	2361	4265	9.7	10.8	14.1	11	5.4	2.4						
2011	276	2067	4270	9.1	7.8	12.2	12.2	10.2	4.6	1.8					
2010	289	1408	3382	8.4	6.5	8.4	10.6	11.9	7.7	5	3.8				
2009	258	1000	2820	7.9	6.4	6.1	7.7	8.9	8.5	8.4	7.4	4.9			
2008	323	742	3060	8.2	5.4	6	6	6.3	6.3	7.8	12.1	11.1	6		
2007	336	979	4162	7.8	3.7	4.9	5	5.6	5.2	6.1	9.5	11.8	10.7	8.6	
2006	392	854	3968	7.7	4.7	3.8	3.7	5.1	4.3	4.5	6.1	7.7	14.3	14.5	7.5
Total															
	3008	25985	45682	8.1	7.7	8.2	8.1	7.4	5.7	5.7	8.2	9.8	11.3	12.9	7.5

Source: Bloomberg

There are merits to SBA 7(a) loan securities for investors looking for floating rate, guaranteed instruments. SBA pools have historically provided yields that outperform most short-term and many long-term investments of a similar nature. Drawbacks include high prepayments as well as fluctuating demand for the securities on the secondary market. We consider SBA 7(a) loans to be buy and hold investments and investors should be prepared for prepayments to lower their exposure over time.

Summary:

Benefits of SBA 7(a) loan pools:

- Full faith and credit of the United States government.
- Exposure to floating rate securities with competitive yields; positive spread to cost of short-term funds.
- Low duration additions to portfolios.

Negatives of SBA 7(a) loan pools:

- High prepayment speeds after years 2-3.
- Little transparency in terms of investor demand for pools; secondary market for select pools can be illiquid.
- A recession will likely lead to a large uptick in prepayments (defaults).

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Emad is the Managing Partner and Chief Executive Officer of Vanderbilt Avenue Asset Management LLC. Vanderbilt's client base includes Multi-national Corporations, Public Funds, Foundations/Endowments, and Taft Hartley accounts.

Previously, Emad was Chairman of Institutional Business at Pioneer Investments. Pioneer investments has more than $300 Billion in assets under management. The parent of Pioneer, UniCredit S.p.A., is the largest bank in Italy and the second largest bank in Europe. Pioneer had purchased Vanderbilt Capital Advisors, of which Emad was the founder and Chief Executive Officer.

Emad has had numerous articles published in professional and academic journals such as The Journal of Forecasting, The American Economist and The Journal of Fixed Income. He is a Board member of The National Investment Company. Emad was a member of the Board of Advisors of the Pacific Institute, The Advisory Committee of Fulcrum Global Partners, The Chief Executive Officers Club and formerly a board member of The Foreign Policy Association. He also served on the Board of Directors of the University of Albany Foundation, NextGen Healthcare Inc., The Park Avenue Bank, AA Bank and The New Providence Fund and Associates LP.

Emad is an FINRA Arbitrator. He is also a member of the National Association for Business Economists and The Economic Club of New York. Emad served as an adjunct professor at the University of Kansas and St. John's University.

Emad holds a Bachelor of Science from the University of Albany, and a M.A. and Ph.D. in Economics from the University of Kansas.